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CHINA, THE EU AND THE WORLD: GROWING IN HARMONY?

中国 , 欧盟与世界: 在和谐中共同发展

by

Frederic Lerais
Mattias Levin
Myriam Sochacki °
Reinhilde Veugelers °°

° Responsible for the political part (myriam.sochacki@ec.europa.eu);
°° Responsible for the economic part (reinhilde.veugelers@ec.europa.eu)

July 2006

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The European Commission – under the responsibility of the Commission departments for Trade and External Relations – is in the process of reviewing its policy strategy as regards China. A request was made for BEPA to write a report (i) reviewing where China stands on its development path, (ii) assessing what challenges it is facing, and (iii) analysing what this implies for Europe and its policy stance. Subsequent to that request BEPA organised a GEPA meeting on China in December. This report is a follow-up to that meeting and provides a background for reviewing the EU's China strategy.

In drafting the report, the authors have benefited from prior research and work carried out by other Commission departments, notably Economic and Financial Affairs, Enterprise and Industry, Environment, Trade, and External Relations. Specific reports and notes by these services have been used as references throughout the report. The policy conclusions of the report were discussed with members of the President's Office, the External Relations and Trade departments. The authors also benefited from comments by GEPA members and BEPA colleagues. Any remaining errors are the responsibility of the authors.

The opinions expressed in this paper are solely those of its authors and do not necessarily reflect the views of the European Commission.

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Abstract

During the last decade, China has become a major global economic and political player. China's economic development has been extraordinary; with average annual GDP growth rates close to 10%, it has become the third largest exporter globally. Nevertheless, the GDP *per capita* numbers underline how far China's standard of living is still lagging behind and how far distant the goal of a "well-off society", emphasising a more social and environmentally friendly path to development, still is. In line with China's economic rise, the country has come to occupy a prominent place on the EU policy agenda. China is now the EU's second most important trading partner, after the US, while the EU has become China's top trading partner. This report will first analyse what forces have been driving China's current development. The second part will try to identify how China will evolve in the future and what challenges to its long-term sustainable development it is facing. The final part analyses the impact of China's current and future development for the EU and its policy stance. It concludes with recommendations for an EU policy on China.

摘要

在过去的十年间，中国已经成为全球政治经济的重要一员。中国经济发展迅速，GDP (国内生产总值) 年平均增长率高达 9%。但是中国人均 GDP 数字却突出表明了中国生活标准的落后程度以及离注重社会和环境问题的"和谐社会"目标的距离。随着中国经济的崛起，中国也在欧盟政策议程里占有突出的位置。中国现在是欧盟的第二大贸易伙伴，而欧盟更是已经成为中国最大的贸易伙伴。本报告首先分析中国经济发展的推动力量。第二部分试图推断识别中国未来将如何发展及其长期可持续发展所面临的挑战。最后部分分析中国目前及未来发展对欧盟和其政策制定的影响。报告结尾为欧盟中国政策提出建议。

01_2006_4142_txt_EN.indd 3 12-07-2007 10:43:03

PREFACE

In the course of the last decade, China has become a major global economic and political player. This development has been triggered primarily by the economic policy changes launched in the late 1970s, gradually opening up the economy to the forces of global markets. This process has been unquestionably positive for Chinese citizens, who are leaving behind decades of poverty. Since the start of the reforms, national income (GDP) has grown at an average annual rate close to 10%. China has accordingly closed a substantial part of the gap with the developed world. In 2004, China is the third biggest economy in terms of GDP (adjusted to differences in purchasing power) after the US and the EU and way above Japan and India and a major trader on world markets. Nevertheless, it still has a long way to go. Despite the specific sectoral segments in which China is competing on a global scale, the economy as a whole is still struggling with underdevelopment and poverty, especially in the western provinces. Working to close the remaining gap will require that China, while opting for a more social and environmental friendly, "harmonious" path to development, be nonetheless able to maintain the dynamics of its recent growth performance.

But beyond the internal challenges, China's rise raises important questions for the international community. Over the last decades and under unchanging single-party rule, China has evolved from a revolutionary state to a relatively status quo state and from diplomatic isolation to an impressive expansion of its diplomatic commitments. Along the road China has developed at least a dual identity, with regular real tensions between the two identities; one is the sovereign nation, aiming to establish a "rich state and strong army" so as not to be humiliated again, and the other is the self-proclaimed "responsible major power", whose integration in the international community is quite remarkable having regard to the country's level of development. China has indeed claimed a prominent place on the global agenda and more specifically on the EU's policy agenda. The debates around the arms embargo and textiles imports in 2005 illustrate how important China has become for Europe, both as an economic and as a geopolitical player. China is now the EU's second most important trading partner, after the US, while the EU has become China's top trading partner.

In drafting this report, the authors set out to answer three questions: (i) Where does China stand on its development path? (ii) What challenges is it facing? (iii) What does China's rise imply for the world in general and the EU and its policy stance in particular? Given the extent to which politics and economics are increasingly indivisible, the report will both consider the economic as well as the political dimension of China's development. Accordingly, Part I of this report analyses where China is today. It analyses China's political system and the sources of its current economic growth. It continues with an analysis of China's position in the world economy and its evolving foreign policy. Part II reviews a number of the significant challenges to its long-term sustainable development, including challenges to the macro-economic policy framework, the financial and production system, public finances, innovative capacity, labour markets, social cohesion, environment and the political and legal system. Finally, after taking an in-depth look at the strengths and weaknesses of the Chinese development process, Part III analyses the impact of China's continued rise for the EU. Starting off with an analysis of the economic impact on the EU, it continues with a description of the EU's current policy vis-à-vis China, concluding with recommendations for a future EU China policy.

The result is, unsurprisingly, a lengthy report. A few remarks to assist the intrepid reader: the *Key Questions and Policy Recommendations* of this report are summarised in the box on the

01_2006_4142_txt_EN.indd 4 12-07-2007 10:43:03

following three pages. The more detailed findings of the three parts of the report underpinning our Key Policy Conclusions are found in the *Executive Summary*. For readers interested only in specific issues, the *Table of Content* lists the different chapters of each part. Furthermore, each of the *Three Parts* is preceded by a short summary providing the gist of the argument and an outline clearly indicating the focus of each chapter.

The authors, Brussels, July 2006

01_2006_4142_txt_EN.indd 5 12-07-2007 10:43:03

Table of contents

PREFACE ..... **IV**

KEY QUESTIONS AND POLICY RECOMMENDATIONS ..... **IX**

EXECUTIVE SUMMARY ..... **XIII**

PART I: WHERE DOES CHINA STAND TODAY? **1**

1. THE POLITICAL SYSTEM **2**

1.1. "Socialist democracy" with Chinese characteristics 2
1.2. Administrative division 4
1.3. Main political institutions 5
1.3.1. The Chinese Communist Party (CCP) *6*
1.3.2. The legislative body: the National People's Congress (NPC) *9*
1.3.3. The Presidency *10*
1.3.4. The executive body: the State Council *11*
1.3.5. The leading small groups (lingdao xiaozu) *11*
1.3.6. The Central Military Commission *11*
1.3.7. The Judiciary *12*
1.4. The People's Liberation Army (PLA) 12

2. THE SOURCES OF ECONOMIC GROWTH **15**

2.1. The economic policy framework for growth 16
2.2. The contribution of capital, labour and other factors to growth 18
2.3. The private sector 21
2.4. Foreign Direct Investment 23
2.4.1. The political framework for FDI *23*
2.4.2. FDI Inflows and the Modernisation of China's Industry *24*
2.5. China's high-tech industries and the role of FDI 29
2.6. China's Science & Technology 31
2.6.1. China's striving for S&T development *31*
2.6.2. Government funding of S&T *32*
2.6.3. Human Capital for S&T: tertiary education *33*
2.6.4. China's S&T performance *35*
2.7. Conclusion 37

3. CHINA'S POSITION IN THE WORLD ECONOMY **40**

3.1. China's position in Global Trade 40
3.1.1. China's Trade by geographical area *41*
3.1.2. China's comparative advantage in world markets *44*
3.1.3. China's role in the international division of labour *47*
3.2. Outward-Bound FDI – One Step Further Towards Global Significance 49
3.3. The impact of growing energy and raw materials demand in China 50
3.4. Conclusion 51

4. CHINA'S EVOLVING FOREIGN POLICY **53**

4.1. World views of China 54
4.2. China's reassurance policy 56
4.3. The regional opening-up of China's foreign policy 58
4.3.1. Central Asia *58*
4.3.2. South-east Asia *61*
4.3.3. The limits of China's influence over Asia *61*
4.4. China's "go global" energy policy 70
4.4.1. Africa *70*
4.4.2. Middle East *73*
4.4.3. Latin America *73*
4.5. Conclusion 74

01_2006_4142_txt_EN.indd 6 12-07-2007 10:43:03

PART II: WHAT CHALLENGES IS CHINA FACING? 75

5. SECURING A BALANCED MACRO-ECONOMIC ENVIRONMENT 76

6. UPGRADING THE FINANCIAL SYSTEM 78

6.1. BANK FINANCE 78
6.1.1. A large and growing banking system 79
6.1.2. Addressing precarious financial positions 80
6.1.3. Consolidating a commercial culture 82
6.1.4. Foreign presence 82
6.2. CAPITAL MARKETS 84
6.2.1. Equity markets 85
6.2.2. Bond markets 89
6.2.3. Investment funds 89
6.3. INFORMAL FINANCE 90
6.4. CONCLUSION 91

7. REFORMING THE PRODUCTION SYSTEM 92

7.1. REFORMING CHINA'S PUBLIC SECTOR 92
7.2. REFORMING CHINA'S PRIVATE SECTOR 94
7.2.1. Financial constraints 94
7.2.2. Barriers to entry 95
7.2.3. Barriers to exit 95
7.2.4. Legal barriers to operation and expansion 95
7.2.5. Barriers to trade 96
7.2.6. Barriers to competition 96
7.3. CONCLUSION 98

8. REFOCUS PUBLIC FINANCES 99

8.1. RAISING REVENUE 99
8.2. ALLOCATING REVENUE 100
8.3. SPENDING 102
8.4. BUDGET BALANCE 103
8.5. REFOCUSING EXPENDITURE TO ADDRESS SOCIAL CHALLENGES AND PROVIDE A BETTER FOUNDATION FOR GROWTH 103
8.5.1. Social insurance 104
8.5.2. Education 106

9. DEVELOPING CHINA'S INNOVATIVE POTENTIAL 108

9.1. CHINA'S STRENGTHS IN BUILDING INNOVATIVE CAPACITY 108
9.2. CHINA'S CHALLENGES IN BUILDING INNOVATIVE CAPACITY 109
9.2.1. Developing the public research infrastructure 109
9.2.2. Developing private research 111
9.3. CONCLUSION 113

10. ABSORBING SURPLUS LABOUR 114

10.1. TRENDS IN CHINA'S LABOUR MARKET: RURAL VS. URBAN EMPLOYMENT 114
10.2. UNEMPLOYMENT: AN UNDERSTATED PHENOMENON? 116
10.3. PROJECTIONS ON CHINA'S LABOUR MARKET: CAN DEMAND MEET SUPPLY? 117
10.4. LABOUR MARKET REFORMS 118
10.5. CONCLUSION 119

11. ADDRESSING THE INCREASE IN INEQUALITY 120

11.1. INCREASING DISPARITIES IN ECONOMIC OUTCOMES 121
11.2. REASONS FOR INCREASES IN DISPARITIES 122
11.3. CONCLUSION 124

12. ADDRESSING ENVIRONMENTAL CHALLENGES 125

12.1. POLLUTION CONTROL 125
12.2. EFFICIENT USE OF NATIONAL RESOURCES 125

13. ADAPTING CHINA'S POLITICAL AND LEGAL INSTITUTIONS TO A TRANSFORMED SOCIETY 126

13.1. A CHANGING SOCIETY 126

01_2006_4142_txt_EN.indd 7 12-07-2007 10:43:03

13.1.1. Emergence of a middle-class *127*
13.1.2. The young urban entrepreneurs *128*
13.1.3. The return of foreign-educated Chinese *128*
13.1.4. The emergence of a new political generation *129*
13.2. A Communist Party in search of legitimacy 130
13.2.1. Nationalism *130*
13.2.2. Inner party democracy *131*
13.2.3. Grassroots democracy *131*
13.2.4. China's civil society *132*
13.3. A dual approach to society 134
13.3.1. The caring approach *134*
13.3.2. The repressive approach *135*
13.4. Improving the legal system 136
13.4.1. From rule of man to rule of law *136*
13.4.2. Enforcement and implementation *136*
13.5. Conclusion 137

PART III: WHAT CHALLENGES IS EUROPE FACING? 139

14. THE ECONOMIC IMPACT OF CHINA'S RISE 140

14.1. EU trade and China 140
14.1.1. Overall Trade Position *140*
14.1.2. Trade Position by Member State *142*
14.1.3. Trade Position by Sector *142*
14.1.4. EU-China competitiveness trends *145*
14.2. FDI from Europe into China 147
14.3. Trade performance of foreign firms investing in China 149
14.4. Conclusion 150

15. CURRENT EU-CHINA POLICIES 151

15.1. Current EC objectives and institutional set-up 151
15.2. EU – China trade policy 153
15.3. EU and China: two visions of foreign policy 154
15.3.1. Human rights *155*
15.3.2. Good governance *155*
15.3.3. Multilateralism *156*
15.3.4. International order *156*
15.4. The EU, its Member States and China: a complex picture 156
15.5. The EU, the US and China: the risks of a triangular relation 157
15.5.1. The EU and the US – two different perspectives on China *157*
15.5.2. The EU's and the United States' shared interests towards China *158*

16. EU POLICY OBJECTIVES 160

16.1. Base policymaking on a sound understanding of China 160
16.2. Help China succeed 162
16.3. Maximise economic opportunities and minimise risks for EU firms 162
16.4. Improve Europe's capacity to adapt 163
16.4.1. Improve competitiveness *163*
16.4.2. Facilitate transition *164*
16.5. Maintain and promote an open world economy 164
16.6. Promote 'harmonious' international relations 166

REFERENCES 169

LIST OF TABLES, GRAPHS AND BOXES 172

LIST OF ACRONYMS 174

01_2006_4142_txt_EN.indd 8 12-07-2007 10:43:04

KEY QUESTIONS AND POLICY RECOMMENDATIONS

Where does China stand on its development path?

Over the last three decades China has experienced a remarkable transformation. Since the comprehensive political and economic reforms initiated in the late 1970s, and which have achieved full speed since 1992, the economy has grown by more than 9% per year on average, and a large part of the economy is now in private hands. An important component of China's development is its integration in the global economy. China has captured an increasing part of world trade and investment flows. It has become the third largest exporter in the world. In some important areas, like ICT, China already became the largest exporter.

Notwithstanding this impressive performance, China is facing daunting challenges. Continuing to pull China's population out of poverty requires sustained growth for a long period of time. Moreover, China's long-term growth strategy calls not only for more wealth, but for a "harmonious" society where wealth is more evenly distributed and where growth is based on technology, economic efficiency and low consumption of natural resources.

Will China succeed in addressing the challenges?

At this stage, it is difficult to know whether the foundations underpinning the current performance are sufficiently sound to deliver this vision of a "harmonious" society. In order to overcome these challenges, not only do the reforms agreed upon so far need to be effectively implemented; they also need to be broader and deeper. A number of areas warrant particular attention in this respect, such as continuing reforms of the financial, product and labour markets and improvements to China's innovative and legal capacity. Overall, the biggest challenge for China is that the challenges that have been pinpointed cannot be tackled in isolation. Instead, they need to be dealt with systemically. If not, failure to progress sufficiently in one area may hamper progress in other areas.

Whether the current political leadership will be able and willing to address the challenges is uncertain. Addressing the future set of challenges requires reforms that will increasingly go to the heart of the current system. Changes are likely to be of such a fundamental nature that they will eventually restrain the leadership's direct control and stewardship of the economy and society. The reforms adopted so far have been managed within the current autocratic institutional setting. The remaining challenges, and the way they are addressed, illustrate a fundamental issue: how far can a one-party autocratic state liberalise the economy without further liberalising society and the political system? For example, dealing with the dysfunctional banking system requires allowing more private ownership of banks. This would, however, remove an important policy tool from the government's hands. Equally, any drive to address regional inequalities requires the liberalisation of the currently fragmented labour market, thereby allowing people to seek economic opportunities where they are. That would, however, disable the government's close control of the population. Moreover, as private firms become more common, China needs to set up the normal checks on companies' behaviour, e.g. as regards collusion or abuse of dominant positions. However, the effective enforcement of competition policies requires an independent competition authority, which would mean relinquishing control of yet another industrial policy tool.

In many respects China is very well placed to meet future challenges. The country is endowed with favourable preconditions for growth, the most important being the huge

01_2006_4142_txt_EN.indd 9 12-07-2007 10:43:04

pool of human capital on which it can draw as input for production and as consumers to sell to. The large population displays a strong "entrepreneurial" spirit and a high desire to invest in the future, as illustrated by the high levels of private expenditure on education. Both dimensions reflect a desire for individual advancement, which has been an important driver of current economic performance in China. A remarkable feature of China's rise since 1992 has been the soundness of its economic management. China's leadership has handled major shocks, like the Asian financial crisis and the WTO accession, astutely. Furthermore, the state and civil society have found fairly innovative ways of dealing with the tension between a liberalised economy and a controlled society. So far, while falling short of anything close to Western democratic standards, nevertheless some kind of basic dialogue seems to have been established. The current leadership has been prepared to allow different forms of limited checks on its powers, such as local political pluralism, that offer some form of safety valve for political discontent. Moreover, in the wake of market liberalisation and WTO entry, the rule of law is increasingly gaining ground. Citizens increasingly turn to the judiciary as a way of seeking redress if they are unhappy with certain acts and decisions by the state.

But what about the willingness of political leaders to endorse more profound political reforms in the future? So far the current political leadership has not shown any openness to contemplate more far-reaching reforms, not even in terms of relinquishing significant control, let alone in terms of freedom of expression, association and the like. Interestingly, this slow pace of political reform seems to have encountered an accommodating Chinese society. This can undoubtedly be related to policymakers' ability to deliver economic growth. As long as the current system manages to deliver, its political "acceptability", if not exactly legitimacy, is likely to remain sufficiently high in the eyes of citizens.

However, how citizens' preferences will evolve over time as China develops is an unknown. Will people remain willing to sacrifice political freedoms, such as freedom of expression and association, for expanding economic opportunities and enrichment? Or will they at some stage want both? And what if the economic growth engine starts to splutter? This could happen for various reasons, e.g. failing reforms, unfavourable external economic conditions such as a worldwide recession, or geopolitical hot-spots like the Taiwan issue turning into a military scenario.

The current Chinese economy remains highly sensitive to these inside and outside conditions. Overall, what is clear is that by liberalising the economy, China has set in motion forces that are quietly permeating the whole of society. The current leadership is fully aware of the challenges it faces in the short, medium and long term. The question is whether China will be able to pursue the right reform trajectory and choose the right speed of reform in future. The noteworthy past track record of economic management should engender some significant degree of confidence for the future, at least. What is clear is that economic reforms will come first, political reforms second. A more democratic China may well emerge in the future, but it will not necessarily be a liberal democratic Western-type political model.

Where China is going internally will have an impact externally. So far, China's foreign policy has been mostly devoted to ensuring continued economic growth and development. In the longer term it is uncertain what role China wants to play on the world scene and accordingly what influence it will exercise. The current leadership's resort to nationalism internally as the glue to bind together an increasingly diverse society may become a source of concern for the outside world.

01_2006_4142_txt_EN.indd 10 12-07-2007 10:43:04

What are the implications for Europe and its policy stance?

Where China is going matters for Europe. In line with its economic rise, the country has taken an increasingly prominent place on the EU policy agenda. The EU is China's top trading partner, while China is the EU's second most important trading partner (after the US). That this is not always perceived as an opportunity is indicated by the discussions over trade in textiles and the recent decision to impose anti-dumping measures on certain imports of shoes from China. That China's rise also has a political and security dimension was illustrated by the fractious debate in 2005 on whether or not to do away with the arms embargo that has been in place since the Tiananmen Square incidents of 1989. So given the uncertainty of China's current and future course and the importance for the EU of China's smooth development and integration into the world economy and the international system, we need to understand China better. More particularly:

The EU should base policymaking on a sound understanding of China: the EU needs to continuously assess and report on China's development process and where it wants to go. More fundamentally, however, improving our understanding and knowledge of China requires a refocusing of our local presence and a strengthening of the analytical capacity in Brussels. As specialised knowledge about contemporary China is weak in Europe, this requires a coherent supply response.

The EU should cooperate with China in its development process: an open, growing China is of major benefit to Europe. It is therefore in our interest to assist China in addressing the challenges it is facing in areas where we have useful experience. The EU has traditionally focused on assisting the internal transition and reform process, by helping to improve governance, and strengthen civil society and the rule of law. The EU has several instruments at its disposal for developing this cooperative engagement strategy (e.g. development assistance and international cooperation in S&T). These should be put to strategic use, focusing on policy areas of mutual interest and shared importance. Furthermore, China's experience with sequencing a complementary set of reforms may be instructive for EU policymakers.

The EU should improve its capacity to adapt: the challenge is to improve the European economy so that globalisation and competition from China are no longer a threat to jobs, but an opportunity for growth in the EU. To achieve this, the European economy needs to improve its adaptive capacity. Policy should therefore (i) improve EU competitiveness and (ii) facilitate transition. This is a vast agenda, but the necessary policy responses are well-known and embodied in the Lisbon Strategy. These policies need to be implemented.

The EU should be able to maximise economic opportunities and minimise risks: The Chinese market represents a tremendous opportunity for EU firms. But while there is the potential for a win-win situation, there are many uncertainties. China is a market and a society characterised by rapid flux, where the institutional framework underpinning the economy has not fully kept up the pace, calling for a continued concern of policymakers to eliminate barriers to operations for (foreign) companies.

The EU should continue to promote an open world economy: The EU should keep its markets open in order to allow other countries – including China – to benefit from the opportunities associated with economic openness. But this openness should be reciprocal. An open world economy is in China's best interest: an open trade and investment environment will allow China to capitalise fully on its relative strength. But challenges

01_2006_4142_txt_EN.indd 11 12-07-2007 10:43:04

remain in some areas such as intellectual property rights, standards, public procurement, national treatment and market access in "strategic sectors".

The EU should promote 'harmonious' international relations: Apart from enmeshing China in the institutions underpinning the world economy, it is also important to anchor China in the wider international system. The EU should build on China's desire for a stable environment to pursue and sustain its economic growth. This is a period when the EU should be encouraging China to play a more responsible and constructive role in world affairs and not only to accept but also to implement international commitments;

The EU should prod its Member States into cooperating more on China issues. To engage more effectively with China, the EU needs to establish a more visible political presence. While frequent contacts between EU and Chinesepolicy makers are useful, they would be more effective if the EU were able to speak with one voice. Particularly on trade and FDI issues, Member States too often see themselves in competition for China's attention rather than in cooperation. Naturally, the EU's problems in this respect are generic. Building up a common strategic outlook and vision between Member States on external policy is a long-term endeavour. It is a worthwhile one, though, particularly with respect to China. Divergences clearly sow confusion and decrease the EU's influence in China and the East Asian region at large.

The EU should embrace the potentially unsettling EU-US-China triangle: Europe and the United States have many shared interests. Both agree that the most important issue is to manage China's smooth and peaceful integration into the established global system. They also share the hope that China will rise to become a responsible major power, a reliable economic partner and an increasingly pluralistic and democratic state. Nevertheless, what is at stake is different for the EU and the United States. That is primarily because the EU, unlike the US, has no significant security strategic interests in the region, nor is it expected to act as a regional security guarantor. However, the EU should further develop a security perspective on China. For example, as the question of how the EU would react to a possible crisis in the Taiwanese strait should be seriously considered.

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EXECUTIVE SUMMARY

China's future course is uncertain. But what is clear is that the direction it takes matters for Europe. It follows that a better understanding of China is an important precondition for a sound EU-China policy. This report is an attempt to understand better where China stands on its growth path and to identify what challenges it is facing in the future, with a view to assessing assess what China's current and future development implies for the world at large, and particularly for the EU and its policy stance. This summary reviews the main findings of the report, which have underpinned our key policy recommendations for Europe.

Part I: Where does China stand today?

The first part of the report describes how the political system currently looks like; reviews the sources of current economic growth; examines China's position in the world economy; and finally, considers how China's conduct in the foreign policy arena has evolved as a result of its increasing economic might. When looking at today's China one should not forget China's past of "pride and humiliation". China is not "emerging" as a major economic power, but rather "re-emerging", having accounted for 30% of global GDP at the start of the 18th century. Although this may seem ancient history, the Chinese share the dream of a strong China, and China's leaders have consistently endorsed the core nationalist mission of ending China's national humiliation.

China's political system

China is a one-party state with a highly centralised political organisation. The core leadership body is the Chinese Communist Party (CCP)'s Political Bureau Standing Committee. Currently composed of nine members, it reflects the continuation of collective leadership into the so-called Fourth Generation of leaders. The transfer of power from the previous generation started in 2002 and was remarkably smooth. Hu Jintao now holds the three most important posts in China's political system: CCP General Secretary, President of State, and Chairman of the Central Military Commission.

A broad political consensus seems to exist on the fact that the Chinese Communist Party (CCP) has to be kept in power, to ensure political stability. However, this critically depends on the CCP's ability to govern an increasingly sophisticated society and to deal with the challenges it faces. Today the Party draws its legitimacy and relevance basically from a mixture of nationalism and the delivery of economic growth. The CCP leadership has so far shown a significant capacity to adapt to changing times. There is notably an acute awareness of the importance of gaining a better understanding of the world and of working out more sophisticated positions, in particular in multilateral organisations. Thus, if the policy process remains basically top-down, it is nonetheless increasingly open to external inputs. Furthermore, the new leadership led by President Hu Jintao and Premier Wen Jiabao seems to be ready to address the two major challenges to the stability of the existing political system, i.e. endemic and rampant official corruption and rising social unrest. It remains to be seen if they will match words with deeds.

One of the most important features of China's recent political evolution has been the reform of its legal system. China has moved a long way from the traditional "rule of man" legal approach. However, the country's progress towards a genuine modern legal system, i.e. the rule of law, is mixed.

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The sources of China's current growth

China is endowed with favourable conditions for economic development and growth. A huge supply of labour, an entrepreneurial drive, a very high savings rate, and a large domestic market all offer opportunities for economic development. However, particularly important for instigating the current extraordinary growth performance have been the reforms to the institutional framework underpinning the economy. China has, since the late 1970s, but particularly since 1992, embarked on a comprehensive programme of **economic reforms**, embodied by the "open door" policy, which decisively opened up the Chinese economy to world markets by encouraging foreign investment and trade. The accession to the WTO in 2001 firmly anchored China in the world forum and provided a further impetus for the reform process.

The accumulation of **capital**, financed for the most part by personal sector savings, has been crucial in driving the increase in GDP. Most of this capital spending is investments in fixed assets (capital construction), reflecting the importance of the industrial sector to China's economic structure. The contribution of **employment** to overall growth, on the other hand, has been very modest, due to the restructuring of employment in the highly inefficient agricultural sector and the State Owned Enterprises. **Education** has played an increasing role, particularly since the mid 1990s, with higher education in particular improving the skill level of the Chinese labour force. Finally, China's growth has been supported by **productivity gains** from the rise of the private sector in the economy. This has improved overall economic performance, as the private sector, domestic and foreign, is more efficient than the state controlled sector. An important factor behind the higher productivity of private sector firms is their participation in world markets. **Foreign Direct Investment** was the catalyst which brought China's economy back onto the global stage. Initially, FDI was mostly aimed at developing export oriented activities. During this early stage, China benefited from the import of capital, employment creation and exports, and from the modern technology brought in by the foreign firms. During subsequent stages of development, foreign investors became more motivated by market access. Currently, China is trading access to the Chinese market against foreign investors' technological and organisational know-how.

Although the growth in FDI into China has been impressive, a closer look at the data lends more perspective to the importance of FDI for the sustained development of the Chinese economy. The bulk of China's massive FDI inflows have not originated in the world economy's centres of technological growth. Hong Kong, Taiwan and other countries in South East Asia have been the most important investors in China. Furthermore, China's FDI inflows have been heavily concentrated in the coastal provinces, with little sign of dispersion towards western China. Similarly, the openness to FDI remains heavily regulated. Sectors that have put restrictions on foreign investments include cars, petrochemicals, financial services, air transport, media and electricity.

China's economic policymakers are aware that having China as the global centre for labour-intensive, low-skilled processing manufacturing will not be sufficient to sustain growth performance in the longer term. The current focus of China's industrial policy is on promoting and establishing higher value added, technology-intensive industries and the country's own indigenous (innovative) capacity.

- ***China's High-Tech.*** The contribution of high-tech industries (particularly ICT sectors) to manufacturing value added has increased to ratios comparable with most Western economies. Foreign firms account for more than half of the value added in

01_2006_4142_txt_EN.indd 14 12-07-2007 10:43:05

China's high-tech industries. Nevertheless, their share in R&D expenditures has not been in line with their share in value added. The reluctance to locate R&D in China is due to insufficient protection of intellectual property. Nevertheless, surveys show that foreign high-tech firms plan to increasingly locate R&D in China. Due to WTO-related reforms, foreign high-tech enterprises are now in many cases allowed to establish wholly foreign-owned subsidiaries in China, which are more attractive than joint ventures for conducting R&D, since they represent a better way of keeping core know-how proprietary.

- ***China's Science and Technology.*** Gross expenditure on R&D (GERD) as a share of national income has increased substantially and is planned to increase to levels comparable to the West. Although private (local) investment in R&D is growing, the Chinese government remains an important financer of research. This public spending is highly focused on areas where China can force the pace of development: IT, energy, biotech, but also national security (aerospace and laser technology) and frontier research. An important component of S&T growth in China is its huge pool of human capital for R&D, especially scientists and engineers. As a result of the growth in these S&T inputs, China's S&T output – as measured by publications and patents – is growing, albeit from a low base.

China's position in the world economy

As China has gradually become an integral part of the world economy, its economic weight has been increasingly felt by other participants. China has already become a major trading nation in the world economy. Both on the import and export side, China's trade has an eminent South-East Asian regional dimension. An important share of this regional trade is intra-company trade on the part of multinational firms building their value added chain regionally, reflecting the economic integration of the region (notably Taiwan, Hong Kong and PRC). Overall, China has managed to export more than it imports, thus keeping a trade surplus, especially with the US and the EU. The large deficits in all areas of intermediate trade and surpluses in final goods suggest that China is still mainly an assembly country. A few trends are nevertheless noteworthy:

- ***Comparative advantage in ICT***. China's future position is very likely to shift away from its role as pure assembly country. While resource-intensive, low-tech and labour-intensive products lay at the core of export activities in the 1980s, China's export structure has since changed dramatically. China has improved its comparative advantage – as illustrated by positive and strongly increasing Relative Comparative Advantage (RCA) values – in medium-tech and more capital-intensive products, most notably ICT. In 2004, China overtook the US to become the world's leading exporter of ICT goods. At the same time, it is shifting its import demand. While China previously relied on electronic components (e.g. computer chips) imported from the US and the EU, they are now increasingly being produced in China and/or sourced from other Asian countries. As a consequence, China runs a trade surplus in ICT, both with the US and with the EU, and this surplus continues to rise.
- ***Outward FDI limited but increasing***. FDI could provide a way for large Chinese companies to expand abroad and gain access to distribution channels, trademarks and technology. However, in comparison to the huge flows of inward-bound FDI, outward-bound FDI remains minor. Nevertheless, rising outward investment by Chinese enterprises signals a new stage in the country's integration into the global economy. Most of the investment coming out of China is still motivated by ensuring access to resources. Nevertheless, commercial and strategic interests of individual enterprises are increasingly driving outward FDI activities.

01_2006_4142_txt_EN.indd 15 12-07-2007 10:43:05

- ***China's growing demand for energy and raw materials.*** High growth rates and rising importance in global terms inevitably mean that developments on the Chinese market are having an ever stronger influence on global demand, supply and prices. This is illustrated by developments in world commodity and energy markets. China's increasing oil consumption has been covered almost entirely by imports. The suddenness of the change in certain sectors may also imply that a smooth supply response cannot necessarily be assured. At this stage, it is impossible to make predictions about the impact of Chinese import growth on prices.

China's evolving foreign policy

With China's integration into the world economy comes the inevitable counterpart: increasing dependence on external markets, including foreign energy resources. At the same time, China's increasing economic wealth, coupled to its status as a permanent member of the UN Security Council and its nuclear capability, is giving the country a growing influence on the foreign policy scene.

China is very much aware of the concerns raised by its rapid development, and is at pains to reassure the international community that its rise is a long-haul peaceful process based on a cooperative approach which is respectful of the current international system and not out to challenge it. Should China put an end to this peace and development line, this would signal a fundamental and worrying policy shift.

China's foreign policy approach is mainly based on the Five Principles for Peaceful Coexistence, which include respect for sovereignty and territorial integrity, and non-interference in internal affairs. Its current approach to foreign policy is determined mainly by its strategy of sustaining a high level of economic development and prosperity, to protect its key economic assets, and to maintain a stable and safe regional and internal security environment.

- Since the mid 1990s China, both inspired by its vision of a multipolar world and driven by concern for its reputation and image as a high status power, has increasingly become active in a number of regional and multilateral organisations, while not neglecting bilateral ties. China's most significant foreign policy development and success is certainly its proactive regional policy, which correlates with the growing economic integration of the region. Regional interdependence is probably conducive to a more stable environment. However, the region remains very unstable, with hotspots such as Taiwan, the Korean Peninsula, and a number of long-standing maritime disputes. As China's key economic assets have tended to become concentrated along its eastern and southern coastline, its vulnerability to maritime threats has increased. In this context China's lack of transparency over its military build-up is a matter of concern for its neighbours. Furthermore, while the countries of the region are very diverse – with differing political systems and different levels of development – no clear regional leadership has emerged so far. China, Japan and India, not to mention the United States, all remain important players in the region.

China's "go global" policy is basically an economically driven policy which is pushing it to search for natural resources abroad, in Africa, the Middle East and Latin America. This policy may alleviate some of the problems being encountered by a number of countries, especially in Africa. However, the energy issue is much more than an economic issue. China's foreign policy vis-à-vis these countries, which gives little room to considerations other than China's own pragmatic economic interests, poses notably the risk of undermining the capacity of the international community to influence countries in

01_2006_4142_txt_EN.indd 16 12-07-2007 10:43:06

terms of good governance, human rights and political freedom. This may ultimately undermine China's own efforts to be seen as a responsible global power.

Part II: What challenges is China facing?

In spite of China's impressive economic development since the launch of the reform process, the remaining objectives are daunting. Pulling all of China's population out of poverty will require sustained high growth over a long period of time. Moreover, China's long-term growth strategy calls not only for more wealth, but for a "harmonious society" where wealth is more evenly distributed among all levels of society, and growth is based more on technology and efficiency of input use. While overall growth remains high, it is far from certain that the economic foundations are sufficiently sound to ensure that this objective can be achieved. The slowdown in productivity growth in recent years reflects a number of residual challenges, attributed to insufficient flexibility in labour, capital and product markets to stimulate productivity. In order to overcome these, not only do agreed reforms need to be effectively implemented – broader and deeper reforms are needed. A number of areas warrant particular attention in this respect:

- ***Macro-economic challenges***. An ongoing challenge in a rapidly growing economy is the provision of a stable macro-economic climate. While inflation has been relatively low, it has been volatile. Domestic monetary policy has not been very successful in managing aggregate demand. The existence of a relatively fixed rate of exchange against the dollar has exposed the economy to inflationary or deflationary impulses stemming from fluctuations in the effective exchange rate.

- ***Refocusing public finances.*** Public finances have grown faster than the economy, but remain low by international standards. They are by and large in a healthy state, with a limited budget deficit and low national debt. However, (i) expenditure is not sufficiently focused on China's upcoming challenges, especially on social insurance (pensions and health) and education, (ii) revenue is often raised in a distortive and opaque manner, and (iii) poorer regions and counties have difficulties in financing their expenditure obligations.

- ***Reforming financial markets***. Probably the greatest liability to the Chinese development process is the undeveloped financial system and the poor performance of the banking sector and its dismal relationship with the state-owned enterprise sector in particular. The banking sector is highly successful in pooling savings, but assigning these savings to investment projects conducted by state-owned enterprises amounts to their annihilation. A large share of credit allocated by the banking sector has turned into non-performing loans (NPL). China has implemented significant reforms to its financial sector, including opening up to foreign ownership. However, it remains to be seen whether these reforms will diminish the state's pervasive influence, as illustrated by its past and current subordination to industrial policy objectives.

- ***Reforming the state sector***: The state-owned enterprises are not only the main recipients of bank credit but also the main source of non-performing loans (NPL). These enterprises therefore need to restructure their ownership and governance. However, not all state companies are suitable for sale or infusion of outside capital. Non-viable companies should be faced with a real threat of being wound up if they are insolvent. This means allowing these enterprises to make staff redundant or reduce their workforce to the numbers that are really necessary for business activity. While concerns about potential job losses if firms go bankrupt are understandable, an even

01_2006_4142_txt_EN.indd 17 12-07-2007 10:43:06

greater reliance on market bankruptcy in the short term is advisable in order to reduce risks to the banking system and improve the competitive environment.

- ***Providing the framework conditions for developing the private sector***: China's "national champions" policy in "strategic sectors" comes at a cost: an underdeveloped competitive system. As a result, the way resources are allocated and industry is structured is still to a considerable extent the outcome of policy rather than market choices. Despite the WTO rules of "national treatment" there is still no level playing field for all economic operators in China, for domestic as well as foreign firms. Substantial barriers to entry, exit and competition remain. With a general antimonopoly law likely to be in place soon, China will have a fairly complete set of competition laws. Law enforcement will then be the biggest challenge facing the country. One major challenge will be to deal with potential conflicts between industrial policy, FDI policy and competition policy, requiring a sufficiently independent competition authority.

- ***Building Chinese innovation capacity.*** China wants to transform the country into a nation of innovation in 15 years. A new phase of development based on innovation will obviate the danger of relying excessively on low cost to build and maintain China's competitive position in world markets. Moreover, new innovations in energy and the environment will ease the pressure of growth on resources and the environment. Even so, building an innovative society requires an integrated policy at the highest level of the state. The first need is to develop the infrastructure at public research institutes, universities and institutes of higher education. Secondly, and perhaps more challenging for China, the private research infrastructure needs to be improved and better geared to creating innovative products and processes that support Chinese sustainable development. This implies putting the right framework conditions in place for firms to have incentives to invest in R&D, which feeds back to reforms in financial and product markets. Enforcement of intellectual property rights (IPR) remains a major concern for both foreign and domestic innovating firms.

- ***Labour market reforms and demographic challenges***. China's abundant labour supply is the key to its successful transformation into the world's manufacturing powerhouse and the source of a large potential consumer base. At the same time, as long as the supply of labour exceeds the demand for low-cost labour by today's wide margin, it constitutes a threat to sustainable socio-economic development. At the moment China is barely able to stabilise the demand gap for unskilled labour at a level that seems to be acceptable to society. Due to the restructuring process initiated and/or speeded up by China's WTO accession, millions of jobs will be shed by China's state-owned enterprises and its agricultural sector in the next years. Moreover, despite China's enormous pool of labour, there is a real shortage of skills in key areas, which is impacting on staff retention and pay. Therefore, further reforms in the labour market are needed to improve labour mobility geographically, across sectors and skills. In the longer term, two major demographic challenges following on from the "one child" policy will come on top of this, namely a gender-imbalanced and ageing population.

- ***Regional disparity***. The policy of regional decentralisation has been an important driver of economic development in China. However, regions which have been allowed to transform themselves and industrialise faster have not been able to pull the other regions with them sufficiently quickly, and the result has been to increase the regional imbalances. The main barrier is to be found in self-enforcing effects that have boosted the location advantages of those regions that were first to embark on the present

01_2006_4142_txt_EN.indd 18 12-07-2007 10:43:06

growth path. These path dependencies may make government involvement necessary in order to correct "market failures", break up vicious cycles, and boost local economic development up to a certain threshold level from where market forces will suffice to attract funds and human resources.

- ***Environmental challenges***. The quality of the environment remains a serious cause for concern in China. There has been progress in introducing pollution control. As a result, emissions of polluting gases rose less rapidly than energy consumption, which has itself risen less rapidly than GDP. However, the level of both water and air pollution remains high. Air pollution is caused mainly by the use of coal with a high sulphur content. New legislation has strengthened the fines for the emission of air and water pollutants. But the major challenge is the effective monitoring and enforcement of laws by local agencies. Another issue is the maldistribution of water relative to requirements. To meet its environmental challenges, China is looking for and investing in new technological developments.

- ***Access to natural resources***. China is not particularly well endowed with national resources to support its growth. To reduce its dependency on imports, it is devising a growth strategy that builds on energy-saving technology and using energy more efficiently. However, this will not be sufficient in the short to medium term. So state-controlled companies are being urged to secure exploration and supply agreements with countries producing oil, gas and other resources. For this, China is increasingly turning to resource-rich developing countries. The Chinese government is courting energy-rich states with bilateral trade agreements, aid, relieving debt, and helping build infrastructure. The international reputation of some of these countries raises major geopolitical concerns. Another important issue with geopolitical implications is that of pipelines and access to sea lanes.

- ***Improving the legal system.*** With a legacy of 'rule of man' rather than 'rule of law', weak enforcement of improved legal and regulatory frameworks has been a recurrent theme of China's economic reforms. WTO accession commits China to improving judicial enforcement of contracts and other business codes, including those governing intellectual property and counterfeiting. However, there has been little fundamental change in the judicial mechanisms for enforcement. Neither the independence of the courts nor their jurisdiction are adequately established. Moreover, the legal obligations of government entities to enforce or obey court decisions are not adequately established, and court decisions are often ignored as a result. Enforcement is further hampered by the limited experience of China's courts of civil law proceedings, and the limited training of judges and other judicial personnel. To improve enforcement, the key objective is to strengthen the independence and clarify the jurisdiction of courts, and to invest in a build-up of judicial know-how.

Political reforms. While the restructuring of the Chinese economy has been rapid, China's political reform process has been lagging behind. One big issue is the timing of political reforms relative to economic reforms. Reforms have been carried out, e.g. modernisation and professionalisation of the bureaucracy and the organisation of elections at grassroots level. Moreover, faced with the daunting challenges of increasing social unrest and rampant official corruption, the new Chinese leadership seems to be making a stand for more transparency, greater accountability, and more distributive justice. The government has also recognised the need for civil society to assist in managing the social consequences of economic liberalisation. It has gradually transferred some of its functions to civil society organisations, though it has also endorsed a number of strict regulations to control their development and activities. These changes should not

01_2006_4142_txt_EN.indd 19 12-07-2007 10:43:06

be underestimated. However, so far the political reform has essentially aimed at adapting the existing political system to a new socio-economic environment by perfecting and reinforcing one-party rule, not by challenging it. The Communist Party retains its grip on power. The Chinese leadership argues that political stability is of the utmost importance for the country, and indeed far-reaching political reform could have a destabilising effect and jeopardise economic reform. However, it is questionable whether economic reform is sustainable in the long term without any deeper political reform. If political opening at the top is persevered with and combined with bottom-up pressure, we may well see the emergence of a new Chinese political era conducive to genuine political reform. But there is no certainty of this happening. Furthermore the new generation of leaders, i.e. the fifth generation, will also be the most diverse elite generation in PRC history in terms of views, values, education and professional background. What comes out of such a highly contrasted new generation remains to be seen. It may lead to a more representative and pluralistic political system or the outcome may be tensions and power struggles.

Overall, the biggest challenge for China is arguably that each of the individual challenges cannot be tackled in isolation, but need to be dealt with in a systematic way, as failure to advance in one area may jeopardise progress in other areas. So far China's leadership has shown a remarkable ability to steer development. The evidence so far gives little reason to doubt China's ability to progress towards its targets, bringing all its strengths into play.

Part III: What challenges is Europe facing?

China's rise is affecting Europe's economy, as illustrated by the sizeable and growing EU trade and FDI and by increasing competitive pressure in certain sectors. China's increasingly active stance in international affairs also has implications for EU foreign policy.

The economic impact on Europe

China is the EU's second largest external trade partner, behind the US. However, China is primarily important for the EU as a source of imports. Accordingly, the EU is currently China's most important trading partner. These are not just low-cost imports. In line with the general trend in Chinese exports, the data for the EU show a remarkable growth of Chinese exports to the EU in high-technology sectors, illustrating that China is increasingly moving into high-technology sectors, particularly IT. Overall, imports from China have grown faster than exports to China, with growing deficits in China-EU trade the inevitable result. Evidence suggests that the trade balance has worsened in nearly all of the broad product groups.

Whereas a growing Chinese economy offers great trading potential and investment opportunities for European business, and offers EU consumers a wider range of better priced products, it may also present challenges for the European economy. Despite the win-win situation in the long run, in the short term the EU needs to adjust and restructure, particularly in those areas where the EU is losing ground and China is building a comparative advantage.

A comparison of China's and the EU's comparative advantages helps to determine how EU firms will be affected by China's rise. To some extent there is a degree of complementarity. In most areas where China is losing competitiveness the EU gains –e.g. *chemicals* and *rubber and plastics* – or is holding its ground, as in *electrical engineering*. In areas where China has gained competitiveness, the performance of the EU is more

01_2006_4142_txt_EN.indd 20 12-07-2007 10:43:06

mixed. In *mechanical engineering* and *electronic engineering* the EU-15's competitiveness has declined. In *computers* – where China's improvement has been most marked – the EU-15 has been only modestly affected. However, this still means being stuck in a low and disadvantaged position. For European firms with no strong comparative advantage in IT sectors, the only opportunity to export to China is in those areas where they command a sustainable technology leadership. While the improvement in China's competitiveness in *cars* is still modest, the trend in China's competitiveness in cars is most likely to be upwards, given that cars have been selected as a strategic sector by the Chinese government. Sometimes, Europe retains an advantage in surprising areas. This is the case for *food & beverages* and *textiles & clothing*, where the EU-15 has been gaining competitiveness. The improved situation for European producers in textiles & clothing reflects the strength of high-end products and luxury brands.

The challenge from China is particularly relevant for the new Member States, which are losing ground in textiles, clothing and leather products, and food & beverages. These are sectors where the new Member States used to perform strongly, but where they currently face stiff competition. In all these sectors China is improving its trade competitiveness.

A considerable share of the EU's trade with China is conducted with foreign firms located in China. Nevertheless, Europe is not one of the most important investors in China. In quantitative terms European FDI engagement is moderate. It is only a very small share of total European FDI outflows that finds their way to China. There is accordingly scope for Europe to develop its investment relationship with China further. The moderate relative share of the West European economies, however, cannot hide the fact that the absolute volumes of China-bound FDI flows have multiplied in recent years.

In the past, European FDI to China has mostly been "resource seeking", and accordingly European investment projects in China are highly concentrated in manufacturing activities. European capital has been attracted by the low cost of production in China and less by the actual size and potential of the Chinese market. Consequently a considerable share of foreign production has been exported, and has not been sold on the Chinese market

The EU's current China policy

The EU has since 1998 been pursuing five long-term aims in its China policy: (i) engaging China more by stepping up the political dialogue, (ii) supporting China's transition to an open society based on the rule of law and respect for human rights, (iii) integrating China further into the world economy, (iv) making better use of existing European resources, and (v) raising the EU's profile in China. A Communication published in 2003 provided an updated list of concrete action points derived from these aims. They form the basis for the European Commission's institutional set-up for ongoing dialogue with the Chinese authorities, ranging from an annual Summit at the most senior policy level, covering all areas, to ongoing detailed discussions at service level in specific policy areas.

In recent years EU-China relations have developed into what is considered to be a long-term "strategic partnership" going beyond trade and economic issues and encompassing regular high-level political contacts, and exchanges on a broad range of sectoral issues. However, the EU-China relationship is often perceived as being restricted to joint declarations on global multilateralism, and promoting democracy, peace and stability, and it seems that the political dialogue has not actually caught up with the reality of intense trade relationships. Moreover, Beijing is viewed as having grasped

01_2006_4142_txt_EN.indd 21 12-07-2007 10:43:07

perfectly well the benefits it can derive from the internal competition between Member States.

01_2006_4142_txt_EN.indd 22 12-07-2007 10:43:07

PART I: WHERE DOES CHINA STAND TODAY?

China has undergone a remarkable transformation over the past three decades. Since the decision to embark on a comprehensive programme of economic reform, starting in 1978 with its "open door" policy, the Chinese economy has grown by 9%per year on average, and a large part is now in private hands. In the course of the last decade, China has become a major player in the world economy, capturing an increasing share of world trade and investment flows. Compared to these huge economic transformations, the changes to China's political power structures have been much more modest, with China remaining a one-party communist state. However, while the Party continues to reign supreme, economic developments are demanding changes to the underpinning institutional framework. Recognising this reality, China's leaders are in a constant process of upgrading the institutional framework. China's increasing economic weight has also brought more attention to the role China plays in the East Asia region, in the world economy and in the international system in general. China's foreign policy is currently evolving, seeking to exercise influence while reassuring its partners about its intentions.

The first chapter of this part presents the contours of China's political system. Chapter 2 reviews China's sources of growth during the last two decades. The third chapter assesses the role China currently plays in the world economy. Finally, chapter 4 analyses how China's international policy stance has evolved as a result of its economic development.

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1. THE POLITICAL SYSTEM

The People's Republic of China (PRC)[1] is an autocratic one-party state, dominated by the Chinese Communist Party (CCP). The Chinese leadership stresses how China's unique conditions make it unprepared to adopt a Western-style democracy. That does not mean that political reforms are rejected *per se*. However, they must be pursued in an orderly way that takes into account Chinese characteristics and does not jeopardise the political and social stability of the country.

The Chinese leadership understands many of the problems it faces and is taking measures to address some of them. However there is no real significant commitment to genuine democratic change, as yet. Nevertheless, the regime's resilience is remarkable. The CCP shows a great capacity to adapt to an evolving society and to become more accountable and somehow less authoritarian while maintaining its grip on power. The current status of China's political system is discussed in this chapter; the pace of political reforms and remaining challenges are discussed in part II of the report.

1.1. "Socialist democracy" with Chinese characteristics

On 19 October 2005 the State Council Information Office issued for the first time ever a White Paper entitled "Building of Political Democracy in China". This publication can be viewed as China's response to Western criticisms over the pace of political reforms in the country. The document presents the argument for a Chinese style of "socialist democracy" – a "choice suited to China's conditions" – and for the continued dominance of the Chinese Communist Party (CCP) over the country's political life. The White Paper gives a detailed account of the foundation, development and principles of China's political democracy. Modern China should indeed always be considered against the backdrop of its past. It is impossible to detach today's China from its history of "pride and humiliation".

Within Chinese society there is a widespread sense of pride in China's culture, ancient heritage and contributions to civilisation. There is often also a sense of injustice and victimisation. China's Communist leaders have always embraced the nationalist mission of ending what is described as China's "national humiliation" and restoring China to its historical position and international eminence. In those nationalistic terms, China is perceived as more than a nation-state; it is one of the great world civilisations "unified by a literary culture and by philosophical and religious traditions whose origins lie deep in antiquity."[2] China's history is characterised by a long period of feudalism, followed in the nineteenth century by a period of "semi-feudal and semi-colonial society" under the "Western imperialist powers."

The White Paper notes that the "Bourgeois Revolution" of 1911 brought an end to that period of deep humiliation. However the parliamentary and multi-party system that was then established "in imitation of the model of Western democracy did not fulfil the

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[1] Throughout the report we use the labels "China" to refer to "People's Republic of China", "Hong Kong" to refer to "People's Republic of China – Hong Kong Special Administrative Region", "Macau" to refer to "People's Republic of China – Macau Special Administrative Region", and "Taiwan" to refer to "Taiwan Province of China". All statistical data presented are based on customs territories. Data for China are therefore restricted to "Mainland China". Statistical data for Hong Kong, Macau and Taiwan are provided separately.

[2] John Friedman, *China's Urban Transition*, University of Minnesota, 2005

01_2006_4142_txt_EN.indd 2 12-07-2007 10:43:07

fervent desire of the Chinese people for independence and democracy". Drawing the lessons from the past, the new democracy that has now developed is "characterised by thorough opposition to imperialism, feudalism, and bureaucratic capitalism".

Box 1-1: A snapshot of China's recent history

Given the length of its history and the richness of its culture, a view of China's history is important to understand its present and its future. Notwithstanding various ups and downs, imperial China spanned a period of over 2000 years.[3] In 1820, China's economy was the largest in the world, accounting for some 30% of world GDP. However, the next 150 years mark China's decline in the world rankings. The combination of anarchy, competing war lords, foreign suppression (e.g. the Opium War, Boxer Rebellion), civil war and the Sino-Japanese conflict saw China's share of the global economy slip to below 5% in 1950. What follows is a snapshot of major events in China's 20th century development up to 1992, which marks the Take Off of China.

1912: Qing's dynasty rule ends with the founding of the Republic of China; creation of the Nationalist Party or Kuomintang (KMT)

1921: China's Communist Party (CCP) created in Shanghai, quickly develops a rural power base. Simultaneously, it develops its own military capability in the form of the Red Army, later turned into the People's Liberation Army (PLA).

1935: the CCP undertakes the Long March to Yanan, an event which gave Mao Zedong the upper hand in the CCP.

1937: Sino-Japanese war starts. Initially CCP and the KMT form a united front, but the war weakens the KMT.

1947: Final phase of the civil war, with the de facto exile of Chiang Kai-shek and the KMT to Taiwan and with the CCP, headed by Mao Zedong, taking power and proclaiming the People's Republic of China (PRC).

1949: end of the civil war, with KMT driven from the mainland and taking refuge on Taiwan.

1958: Mao Zedong launches the Great Leap Forward, i.e. the collectivisation of agriculture, which led to the famine of 1959-1962 in which an estimated 20 million people perish.

1966: Mao Zedong and the "Gang of Four" launch the Cultural Revolution. The aim is to block the rise of the "new bourgeoisie" in the party ranks. This produces violent and widespread upheaval, forcing Mao to order the PLA to step in to restore order.

1976: death of Mao Zedong, Gang of Four arrested and Hua Guofeng becomes Premier. In reality, Deng Xiaoping seizes power.

1978: Deng Xiaoping starts the reform era.

1980: Zhao Ziyang, protégé of Deng, appointed Premier and becomes driving force of reforms, e.g. via the creation of special economic zones.

1982: 12th party congress agrees on building "socialism with Chinese characteristics".

1987: 13th party congress concludes that China at "initial stage of socialism" and primary task is eliminating poverty. But, increasing unease within CCP at impact of economic liberalisation on party authority.

1988: Zhao ousted following the economy overheating and discontent with the changes brought about by economic liberalisation. Replaced by a conservative, Li Peng.

[3] viz. the Zhou, Han, Jin, Sui, Tang, Song, Ming and Qing(Manchu) Dynasties.

01_2006_4142_txt_EN.indd 3 12-07-2007 10:43:07

1989: Li Peng's reining-in of reforms and austerity programmes lead to student protests on Tiananmen Square. Imposition of martial law. The PLA crushes the student uprising. Jiang Zemin becomes party chair.

1992: Dissatisfied by slow progress of reforms, Deng Xiaoping returns from official retirement and undertakes tour of Southern China promoting rapid reform.

Source: Lehman Brothers (2002).

1.2. Administrative division

China is at present divided into 22 provinces, five so-called autonomous regions and four municipalities directly under the Central Government. In practice provincial officials have a large amount of discretion to implement policy goals which are set by the central government and in which provinces and localities actively compete with each other in order to advance economically.

The autonomous regions are province-level divisions with a designated ethnic minority, and are guaranteed more rights under the Constitution. For example, they have a chairman (where regular provinces have governors), who must be of the ethnic group as specified by the autonomous region. The overwhelming majority of the Chinese people (91.6%) are Han. The non-Han population includes 55 ethnic minorities of which the major groups are the Zhuang, Hui, Uighur, Mongolian, and Tibetan.

Figure 1-1: China's provinces

Source: http://www.chinapage.com/map/map.html

China also has two Special Administrative Regions (SAR), Hong Kong and Macau, which enjoy considerable autonomy – separate governments, legal systems and quasi-constitutions (Basic Laws) – but the PRC is responsible for their foreign affairs and defence. The government of the PRC considers Taiwan, which is controlled by the Republic of China, as its 23rd province.

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Table 1-1: Administrative division

Provinces (22)	Anhui	Jiangsu
	Fujian	Jiangxi
	Gansu	Jilin
	Guangdong	Liaonong
	Guizhou	Qinghai
	Hainan	Shaanxi
	Hebei	Shandong
	Heilongjiang	Shanxi
	Henan	Sichuna
	Hubei	Yunnan
	Hunan	Zhejiang
Autonomous regions (5)	Guangxi (*Zhuang*)	Xinjiang (*Uighurs, Turkish speaking Muslims*)
	Inner Mongolia (*Mongols*)	Tibet
	Ningxia (*Hui, Chinese speaking Muslims*)	
Large municipalities (4)	Beijing	Shanghai
	Chongqing	Tianjin
Special Administrative Regions (2)	Hong Kong	Macau
Claimed by the PRC	Taiwan	

1.3. Main political institutions

The CCP and the government structures run in parallel, extending from the centre (Beijing) down to local levels. This territorial organisation is based on a number of administrative divisions, with both a CCP committee and a "people's government" in charge of each. These bureaucracies are assisted by various "mass movements" – trade unions, a youth league, women's associations, writers' and other professional associations – that include key sectors of the population.

According to the Constitution, the National People's Congress (NPC) is the highest organ of state power. However, this is in practice not the case. Real decision-making authority in China is held by the CCP and the State Council, which is led by the Premier. No policy can be made in a ministry without the approval of the Party. However, a remarkable change in the policymaking process was initiated under Jiang Zemin.

The Chinese leadership – aware of the need to get a better understanding of the world and to work out increasingly sophisticated positions, in particular in international forums and institutions – has developed a more consultative and rational policymaking process. It is increasingly relying on intellectuals and experts for policy advice on a broad range of issues[4].

[4] For example on foreign affairs the Chinese leadership relies on the expertise and advice of the China Institute of International Studies, the China Institute of Contemporary International Relations (CICIR), the Chinese Academy of Social Sciences (CASS) or the Fudan University's Centre for American Studies. The People's Liberation Army (PLA) relies among other institutes on the Foundation for International and Strategic Studies, an entrepreneurial group of military intelligence officers, which has done studies for the top leadership on the development of western China; cross-strait relations, national security decision-making, and crisis management.

01_2006_4142_txt_EN.indd 5 12-07-2007 10:43:08

1.3.1. The Chinese Communist Party (CCP)

With a membership of 68 million, the CCP is the largest political party in the world. Since the launch of economic reforms, the Party has however lost its original ideological appeal. New party members are said to be more likely to join because of economic benefits from membership.

The National Party Congress of more than 2 000 delegates is in theory the highest body of the CCP. It meets every five years to elect a Central Committee of some 200 members. The Central Committee meets once a year and elects the Political Bureau (Politburo) and its Standing Committee. The 22-member Politburo, and notably the 9-member Standing Committee, is in practice the party's most powerful body and hence the supreme policymaking council in China. It sets policy and controls all administrative, legal and executive appointments.

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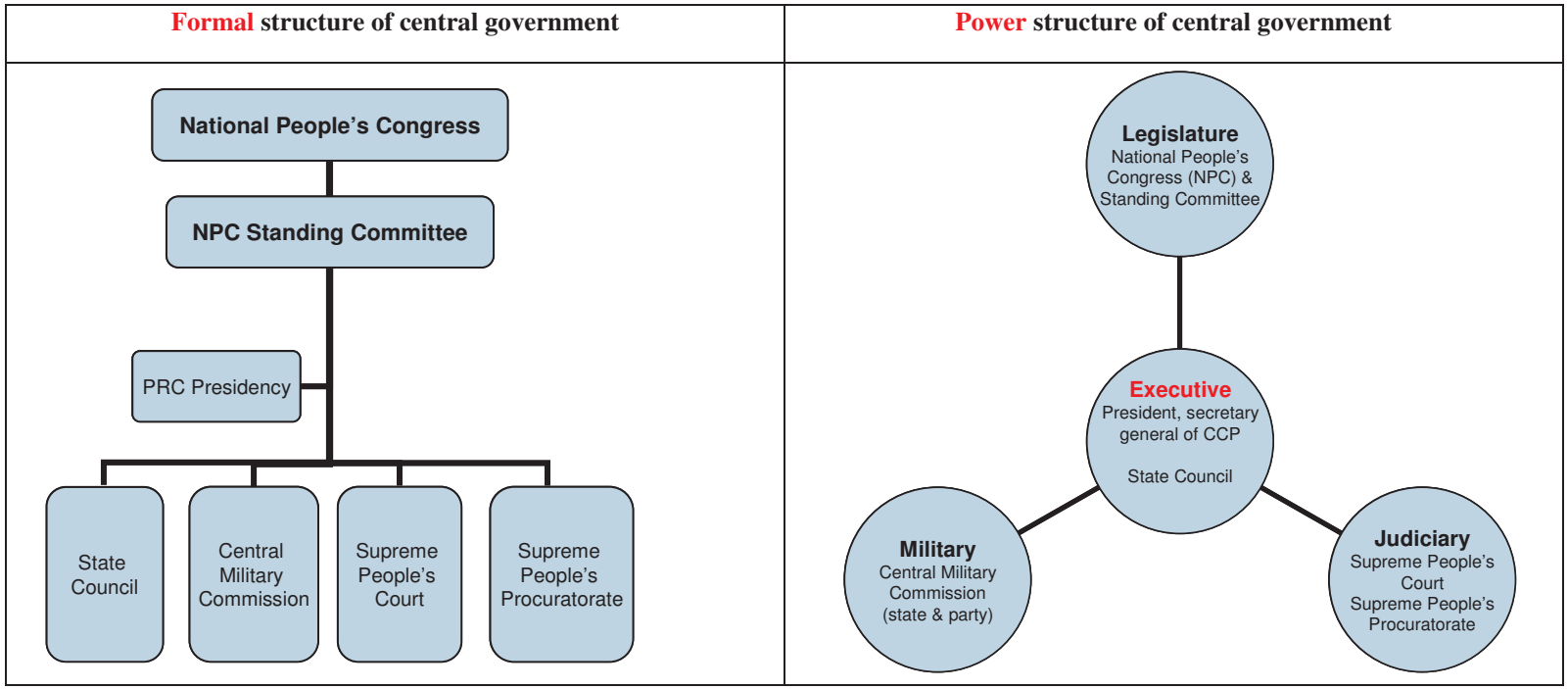
Figure 1-2: China's State Organs



Source: Adapted from Stephanie Hemelryk Donald and Robert Benewick, The State of China Atlas, University of California Press, 2005

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Box 1-2: Members of the Politburo's Standing Committee

In 2002 the 16th Party Congress saw the succession to power of the Fourth Generation of Party leaders. Jiang Zemin stepped down and Hu Jintao was elected General Secretary of the Party.[5] It also saw the opening of the Party to capitalists and private entrepreneurs in accordance with Jiang Zemin's "Three Represents" theory that was then included in the Constitution. The theory refers to the CCP mission to represent three essential concerns 1) the development of China's advanced productive forces, 2) the development of China's advanced culture, and 3) the fundamental interests of the overwhelming majority of the people in China.

Hu Jintao

General Secretary of Communist Party 2002-

President of the PRC 2003-

Chairman of the Central Military Commission of the PRC 2004-

Zeng Qinghong

Vice-President of the PRC 2003 -

Secretary of Central secretariat of CCP 1997 –

President of Central Party School 2002 –

Wen Jiabao

Premier of the State Council 2003 –

Wu Bangguo

Chair of Standing Committee of National People's Congress 2003-

Jia Qinglin

Chairman of Chinese People's Political Consultative Conference 2003 –

Huang Ju

Vice-Premier of the State Council 2003-

Wu Guanzheng

Secretary of Central Discipline Inspection Commission 2002-

Li Changchun

Standing Committee member in charge of the ideological front 2002-

Luo Gan

Secretary of Central Political and Legal Commission 2002-

Note. The Politburo's Standing Committee was expanded from 7 members to 9 in 2002. Hu Jintao was the only remaining member of the previous Standing Committee. Of the 8 new members, 6 are Jiang Zemin's protégés linked to the so-called "Shanghai clique": Zeng Qinghong, Wu Bangguo, Jian Qinglin, Huang Ju, Wu Guansheng, and Li Changchun.

[5] Hu Jintao's leadership marks the first smooth power transition in the history of the PRC. It is a recent transition that has developed progressively, building on the demise of the concept of paramount leader following the death of Deng Xiaoping. Hu Jintao only became Chairman of the Party in 2002, President in 2003, and Chairman of the State Central Military Committee in 2004. For most analysts Hu Jintao's hold on power will be tested in the coming months when the preparations for the 2007 17th CCP Congress will start to be unveiled. Then a number of decisions would have to be followed closely to assess his real power and intentions, that include appointments at provincial and national levels, appointments to the Central Committee, and composition of the Committee in charge of drafting the political report to be delivered by Hu at the Congress.

01_2006_4142_txt_EN.indd 8 12-07-2007 10:43:08

The CCP also has a Central Discipline Inspection Commission that is in charge of detecting and punishing abuses of office by Party members, and a Central Military Commission by which it retains control over China's armed forces. There are party organisations in cities, towns, villages, neighbourhoods, major workplaces, and so on.

Box 1-3: The eight democratic* parties

The White Paper refers to a system of multi-party cooperation and political consultation under the leadership of the CCP, and with the CCP holding power and participating fully in state affairs.

Actually the eight small democratic parties are loyal to the CCP and do not provide any political opposition whatsoever. They are members of the Chinese People's Political Consultative Congress (CPPCC), a powerless advisory body which comprises over 2 000 delegates including scholars, educators, intellectuals, and key representatives of women's organisations, religious bodies and minority nationality groups. The CPPCC meets once a year in conjunction with the National People's Congress (NPC).

The China Zhi Gong Dang (or China Party for Public Interest), founded in 1925, has more than 15 000 members, essentially Chinese who have returned from overseas. The party has many foreign connections.

The Chinese Peasants and Workers Democratic Party, founded in 1930, has some 65 000 members, most of whom work in public health, culture, education, science and technology.

The China Democratic League, founded in 1941, has some 144 000 members, most of them being intellectuals.

The China National Democratic Construction Association, founded in 1945. Party members are mainly entrepreneurs from both private and state sectors. The chairman of the party Cheng Siwei is Vice-chairman of the Standing Committee of the National People's Congress.

The China Association for Promoting Democracy, founded in 1945.

The Jiusan Society, founded in 1945. The party's name commemorates the victory on 3 September 1945 in the Sino-Japanese War and the international antifascist war. It has a membership of over 68 000, mostly intellectuals.

The Taiwan Democratic Self-Government League, founded in 1947, has a membership of some 1 600 people.

The Revolutionary Committee of the Chinese Kuomintang, founded in 1948 by leftists who broke off from the main Kuomintang during the Chinese Civil War. Song Qingling. The party claims to be the true heir of Sun Yat-sen's legacy. It has over 53 000 members.

** "Since most of these political parties were founded during the War of Resistance Against Japanese Aggression (1937-1945) and the War of Liberation (1946-1949) in the pursuit of national liberation and democracy of the people, they were given the joint name of 'democratic parties'"* (from the White paper on Political democracy).

1.3.2. The legislative body: the National People's Congress (NPC)

China's Constitution states that the NPC is the highest organ of state power. The White Paper on Political Democracy emphasises that it represents the common will and fundamental interests of the people. In fact the NPC is heavily influenced by the CCP, which retains a large measure of control over the process of delegate selections. However, in recent years the NPC has begun to move away from its basically symbolic role as a rubber-stamp institution to become a more professional legislature.

The NPC and its permanent body the Standing Committee exercise the legislative power of the State. The NPC passes laws and treaties, elects the executive and approves the Constitution. It is currently composed of 2 937 delegates elected by the provinces,

01_2006_4142_txt_EN.indd 9 12-07-2007 10:43:08

autonomous regions and municipalities and by the armed forces for a five-year term The NPC meets once a year in plenary session, taking stock of government action. Between these plenary sessions, power is exercised by the Standing Committee of the NPC, which comprises 153 members.

Box 1-4: China's eleventh five-year Programme [6](2006-2010)

The 2006 Plenary Session of the 10th NPC met in Beijing from March 5 to March 14. Formal issues listed for discussion included the so-called "*Three Nongs*" problem – agriculture (*nongye*), peasants (*nongmin*), and rural communities (*nongcun*) – and the need to crack down on corruption. Premier Wen Jiabao made the annual Government Report to the Congress outlining government' s work in 2005 and the way ahead with a strong emphasis on helping the poor and closing the wealth gap.

The NPC overwhelmingly endorsed Premier Wen Jiabao's government work report (98.86% in favour) and the Party's suggestions for the eleventh five-year Programme (97% in favour)."The final validation of the government's action plan signifies China's major shift in economic policies from urban development and heavy investment in billion-dollar projects, to increasing rural development and investment in scientific technology for sustainable development," said Li Chong'an, an NPC deputy and vice-chairman of the NPC Law Committee.

The Programme signals a notable shift from "getting rich first" to "common prosperity" and from "growth rate" to "sustainable development". It reflects the Chinese leaders' concerns that a fragile social cohesion may undermine economic growth.

It is firmly inscribed both in the theory of "scientific development" and in the objective of the "five balances" enunciated by the Hu-Wen administration. "Scientific development" means, as Premier Wen put it, "ensuring that GDP expansion would go hand-in-hand with market improvement in employment, social security, poverty reduction, education, medical care and environmental protection." The "five balances" objective points to the need to achieve a more balanced development in five main interconnected areas:

- across geographical regions;
- between urban and rural areas;
- between economic growth and social improvement;
- between the needs of the people and the sustainability of the environment, and
- between the promotion of foreign trade and the need to stimulate China's internal market.

The 11th five-year Programme gives only two quantified objectives: (i) GDP per capita in 2010 should be double that of 2000, and (ii) energy consumption per unit in 2010 should be about 20% lower than it was at the end of the 10th five-year Plan in 2005. The objective is for China to create an economy that economises on resources and that develops along the lines of a "5 R" policy: Rethink, Reduce, Re-use, Recycle and Repair.[7]

1.3.3. The Presidency

Formally the President is elected by the NPC; in practice, this election falls into the category of 'single-candidate' elections. According to the Constitution, the President cannot serve for more than two five-year terms. The President is the Head of State. To date, six men have held the office of the President of the PRC: Mao Zedong, Liu Shaoqi, Li Xiannian, Yang Shangkun, Jiang Zemin, and the current president, Hu Jintao, who was elected on 15 March, 2003. One notable absentee from this list is Deng Xiaoping, who in spite of being paramount leader shunned the highest ranks of either party or state.

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6 The 11th Five Year Plan has been renamed "Programme" to emphasise that qualitative guidelines are progressively replacing quantitative "hard planning".

7 Barry Naughton, *The New Common Economic Program: China's Eleventh Five-Year Plan and What It Means*, China Leadership Monitor, Issue 16, Fall 2005

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1.3.4. The executive body: the State Council

The State Council – the Central People's Government – is the highest state administrative body. It is responsible to the NPC and its Standing Committee, and reports to them on its work. In practice the NPC's actual authority over the State Council is rather limited.

The State Council is composed of the Premier, Vice-Premiers, State Councillors, Ministers in charge of ministries and commissions, and the Secretary General. The President nominates the Prime Minister, who then nominates his government. They are all appointed by the President upon the approval of the NPC. The full Council meets once a month, but the more influential Standing Committee meets twice a week. The Standing Committee accordingly exercises day-to-day decision-making authority, and its decisions *de facto* have the force of law.

The State Council is the functional centre of state power and clearing-house for government initiatives at all levels. With the government's emphasis on economic modernisation, the State Council clearly acquired additional importance and influence. The State Council's most important roles are to draft and manage the national economic plan and the state budget. It also has the power to formulate administrative measures, enact administrative regulations, and promulgate decisions and orders within its functions and powers.

The administrative rules and regulations issued by the State Council rank immediately below the laws enacted by the NPC. However they affect their implementation. By the year 2000, about 250 laws had been promulgated in China, while the State Council had issued over 800 administrative regulations.[8] Such a situation creates some confusion on the ground, including contradictions between laws and regulations.

1.3.5. The leading small groups (lingdao xiaozu)

The leading small groups (LSG) do not appear on organisational papers. They are inter-agency coordinating bodies on key policy issues (e.g. economic affairs, foreign affairs, national security, Taiwan affairs). They have become increasingly important in the PRC since the 1990s, especially in the field of foreign policy. They are sometimes ad hoc and sometimes formal and permanent. They form a bridge between the Politburo and State ministries and bureaucracies. They are composed of members of the CCP and are chaired by Politburo members. On foreign policy, for instance, the decision-making body is the Foreign Affairs leading small group, which is currently chaired by Hu Jintao.

1.3.6. The Central Military Commission

Command and control of China's armed forces, including the People's Liberation Army (PLA), People's Police Force and Civilian Force, is exercised by the CCP's Central Military Commission. Under the 1982 Constitution, the highest military body in the Chinese Government is the State Central Military Commission. In fact, the leadership of both bodies is identical. So the two commissions are practically one body with two identities, reporting to the Party's Central Committee and the NPC respectively. Hu Jintao was elected chairman of the Party Central Military Commission in 2004 and chairman of the State Central Military Commission in 2005.

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[8] Laura Paler, *China's Legislation Law and the Making of a More Orderly and Representative Legislative System*, The China Quarterly, 2005

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1.3.7. The Judiciary

China has a four-tier court system. The *Supreme People's Court* sits in Beijing. *Higher* People's Courts sit in the provinces, autonomous regions and municipalities. *Intermediate* People's Courts sit at the prefecture level and also in parts of provinces, autonomous regions, and municipalities. There are also *basic* People's Courts in counties, towns, and municipal districts. Special courts handle matters affecting military, railroad transportation, water transportation, and forestry. The court system is paralleled by a hierarchy of prosecuting authorities called People's Procuratorates; at the apex of this structure stands the Supreme People's Procuratorate.

The reform of China's legal system has been one of the most important aspects of political system evolution during the process of economic modernisation. These reforms will be discussed in more detail in part II.

1.4. The People's Liberation Army (PLA)

The history of the PLA is officially traced to the NanChang uprising of 1 August 1927 (the first major Kuomintang-Communist engagement of the Chinese Civil War), which is celebrated annually as PLA Day. With its 2.25 million members (3.25 million if active paramilitary personnel are included) the PLA is one of the world's largest military forces in terms of sheer number of troops. It is formally under the command of the Central Military Commission.

The PLA consists of five branches: (i) the Ground Force (including the Army Special Operation Forces); (ii) the Navy (including the Marine Corps and the Naval Air Force); (iii) the Air Force (including the Airborne Force); (iv) the Second Artillery Corps (strategic missile force), and (v) the People's Armed Police (internal security troops nominally and border defence guards subordinate to the Ministry of Public Security). Troops around the country are stationed in seven military regions and more than 20 military districts.

China is in the process of modernising its armed forces and has embarked on a two-phased plan to scale down into a smaller, higher-quality force and to focus on high technology application. According to a senior Chinese researcher, Huang Haiyuang[9] the PLA's modernisation is aimed at seven technological priorities: information operation and warfare; air and missile technology; precision guided munitions; defensive weapon technology; unmanned aerial vehicle technology; and naval carriers. This modernisation process reflects the wish to be in a position to successfully wage local or limited wars under high-tech conditions (i.e. basically to keep the US away from Taiwan, and protect access to natural resources and notably communications sea lanes).

China's defence spending has over the last fifteen years enjoyed double-digit growth. According to the official Chinese state budget the country allocated about $30 billion for military spending in 2005. Most analysts estimate that China is hiding some of its defence spending (the official figures do not include new arms purchases and weapons research and development).

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[9] Quoted by Charles F. Hawkins, *The People's Liberation Army Looks to the Future*, Defence Technical Information Centre (DTIC° summer 2000). http://www.dtic.mil/doctrine/jel/jfq_pubs/0525b.pdf

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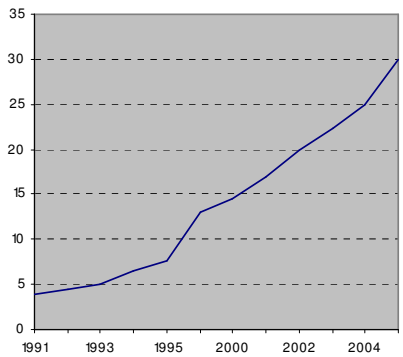
Table 1-2: China's official defence budget

Year	Yuan bn	USDbn	Percentage increase	China's official defence budget (USDbn)
1991	32.5	3.9	-	
1992	37.0	4.5	13.8%	
1993	42.7	5.1	15.2%	
1994	55.0	6.6	28.8%	
1995	63.0	7.6	14.5%	
1999	107.7	13.0	15.2%	
2000	121.3	14.6	12.6%	
2001	141.0	17.0	17.7%	
2002	166.0	20.0	17.6%	
2003	185.3	22.4	9.6%	
2004	206.5	25.0	11.6%	
2005	247.7	29.9	12.6%	

Source: http://www.globalsecurity.org/military/world/china/budget.htm

China's real defence spending is certainly higher than the publicly disclosed figures but probably not the three times higher estimated by the Pentagon.[10] A number of experts believe that China's real level of military spending is about $40 billion to $55 billion, which is actually rather modest for a nation of 1.3 billion people. While understanding China's desire to preserve some secrecy about its military programmes, many observers would welcome a move towards more transparency.

Box 1-5: China's Defence White Paper – Command of the sea, command of the air and strategic counter-strikes

China's fourth Defence White Paper, *China's National Defence in 2004,* shows that China's views of the security environment have been consistent over the last five decades, i.e. the emergence of a multipolar world along with an inevitable relative decline in the United States power *(see also Chapter 4).* The multipolar world will be a turbulent one characterised not by a world-wide war but a number of local wars whose main cause will be struggles over natural resources.[11] Chen Qimao, former President of the Shanghai Institute for International Studies, considers that the world is still in a post Cold-War transitional period marked by the "basic formation of the new multipolar structure", a time where "the old structure has already ended but the new structure has not yet been formed. That is the time of the emergence of one superpower and many strong ones or the so-called 1-2-3-5 layers:

One superpower, the United States;

- Two military powers, the United States and Russia;
- Three economic powers, the United States, Japan and Europe; and
- Five political powers, the United States, Japan, Russia, Europe and China."

Moreover studies from the Centre for Foreign Policy at the China Institute of Contemporary International Relations (CICIR) and the Chinese Academy of Social Sciences (CASS) warn about the dangerous decade to come between 2020 and 2030 when the United States leadership will finally realise that China's power is about to surpass that of the United States.[12]

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10 The US Department of Defence estimates China's defence budget for 2005 at about $90bn. Even if we assume that the US figure is correct the PLA budget would still be a fraction of US defence spending (around $480bn.)

11 Michael Pillsburg, *China Debates The Future Security Environment*, National Defence University Press, January 2000

12 Ibid.

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The 2004 White Paper assesses that "the trends towards world multipolarisation and economic globalisation are deepening amid twists and turns. (…) New and profound readjustments have taken place in the relations among the world's major countries. While cooperating with and seeking support from each other, they are checking on and competing with one another as well. With their overall strength continuing to rise, the developing countries have become important players in promoting a multipolar world and democratised international relations."

The White Paper expresses concerns about the world's major countries which "are making readjustments in their security and military strategies" and more specifically about the increased "complicated factors in the Asia-Pacific region": the United States "is realigning and reinforcing its military presence in this region by buttressing military alliances and accelerating deployment of missile defence systems"; and Japan "is adjusting its military and security policies and developing the missile defence system for future deployment." Furthermore it is "the sacred responsibility of the Chinese armed forces to stop the "Taiwan independence" forces from splitting the country."

The Paper states that "a fair and rational new international political and economic order is yet to be established". It acknowledges that "China's national security environment in this pluralistic, diversified and interdependent world has on the whole improved", however "new challenges keep cropping up." Therefore, "the military factor plays a greater role in international configuration and national security". In this context the White Paper calls for the People's Liberation Army (PLA) to craft military forces capable of "winning both command of the sea and command of the air, and conducting strategic counter-strikes."[13]

Today China's world views seem consistent with ancient Chinese tales of dynastic foundations which highlight the ability of the weak to defeat the strong. The emphasis is put on the artfulness of the conquest including "resolve, patience, sensitivity to disguise, knack for devising ruses and ability to recognize and exploit opportunities."[14]

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[13] http://english.chinamail.com.cn

[14] Jacqueline A. Newmyer, *China's Air Power Puzzle*, Policy Review, June-July 2003

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2. THE SOURCES OF ECONOMIC GROWTH

China's economic growth performance over the last decade has been impressive, outpacing most other OECD countries, as well as other Asian Tigers. Furthermore, unlike many other emerging market economies, China has not experienced any sharp disruptions to growth during this period.

As a consequence of this impressive sustained growth rate, the Chinese economy in 2004 already accounted for 13% of world GDP, substantially closing its gap with the developed world. Nevertheless, as the following table clearly shows, despite these impressive growth rates, the gap in terms of GDP per head remains huge, due to the sheer size of the Chinese population that needs to be brought out of poverty[15].

Average Annual % Change in Real GDP Growth (1994-2004)

China	10%
EU-15	2.8%
NMS-8	4.4%
US	3.6%
Japan	1.6%
Tigers	4.4%
India	6.9%

Note: China excluding Hong Kong; Tigers are Hong Kong, South Korea, Singapore, Indonesia, Malaysia, Philippines and Thailand.

Source: IFS, Eurostat & WIIW

With Chinese GDP per head being only one fifth of the EU-25's, the Chinese economy needs to continue to produce substantial economic growth in future if it wants to reach its target of a "harmonious" or "well-off" society. China's 11th five-year programme (2006-2010) has a stated goal of increasing GDP four-fold between 2000 and 2020, which would imply an annual growth rate of just over 7%. Pursuing a gradually rising and sustainable growth path, China would like to have advanced, by 2050, as a "democratic socialist country on a par with the middle ring of advanced nations".

Table 2-1: China's economy compared

	China	EU-25	US
Nominal GDP, USD bn	1,910	13,459	12,452
GDP at PPP, USD bn	7,334	12,329	11,605
Share of world GDP (PPP, %)	13%	21%	21%
Population, m.	1,297	455	294
GDP per head, at PPP, USD	5,657	27,079	39,540

Source: World Bank Indicator, IMF. All figures are 2004 estimates.

To gaugue the feasibility of China's growth targets, we need to better understand the drivers of current Chinese growth. In comparison to other developing economies, China is endowed with favourable preconditions for economic development and growth: a large supply of labour, an entrepreneurial drive, a high savings rate, and a large (potential) domestic market. However, as other developing countries and China have experienced in the past, resources alone are not sufficient to create economic growth. What is important is how these resources are employed. The institutional framework is particularly critical,

[15] In 2002, China had 180 million people living on $1 a day, down from 334 million in 1993 and 634 million in 1981. As a share of the total population this is 14% in 2002 and 28% in 1993. (*Source*: World Bank Indicators)

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as it determines the incentives according to which economic decisions are made and hence the output that is created out of any given set of resources[16].

Before delving into the drivers of growth, this chapter will therefore first review in section 2.1 the reforms to the institutions underpinning China's economic development. Section 2.2 sketches the contribution of capital, labour and residual factors in a classical growth-accounting framework. The remaining sections examine in more detail some critical components of China's current growth performance, namely the contribution of the private sector (section 2.3) and Foreign Direct Investment (section 2.4). The chapter closes with a discussion of components which will become important for sustaining China's growth performance in the future, namely the high-tech component in China's growth (section 2.5) and the development of an indigenous Chinese Science & Technology base (section 2.6).

2.1. The economic policy framework for growth

Departing from the (economically) inefficient ideological foundations and institutional arrangements of the Maoist era, China has since the late 1970s embarked on a comprehensive programme of economic reform, with its "open door" policy as the centrepiece. Following Deng Xiaoping's southern trip with the proclamation of a "socialist market economy" in 1992, major changes were introduced, which kick-started China's growth. Box 2.1 gives an overview of the most instrumental reforms for economic development.

Box 2-1: Lists of major reforms for economic growth

1978	"Open door" policy initiated, allowing foreign trade and investment to begin
1979	Decision to turn collective farms over to households. Township and village enterprises (TVEs) given stronger encouragement
1980	Special economic zones created
1984	Self-proprietorships (*getihu*) encouraged, of less than 8 persons
1986	Provisional bankruptcy law passed for state-owned enterprises
1987	Contract responsibility system introduced in state-owned enterprises
1988	Beginning of retrenchment of TVEs
1990	Stock exchange started in Shenzhen
1993	Decision to establish a "socialist market economic system"
1994	Company law first introduced
	Renminbi begins to be convertible on current account
	Multiple exchange rates ended
1995	Shift to contractual terms of life-long employment for state-owned enterprise staff
1996	Full convertibility for current account transactions
1997	Plan to restructure many state-owned enterprises begins
1999	Constitutional amendment passed explicitly recognising private ownership
	Regulation on unemployment Insurance
2001	China accedes to the World Trade Organisation (WTO)
2002	Communist party endorses role of the private sector, inviting entrepreneurs to join
2003	Introduction of (or decision on) a social security system
2004	Decision to "perfect" the socialist market economic system

Source: OECD (2005), ILO (2003).

[16] For the importance of "Incentives, Institutions and Infrastructure", see Rodrik, Subramanian and Trebbi (2002)

01_2006_4142_txt_EN.indd 16 12-07-2007 10:43:10

Private enterprises have since the beginning of reforms been regarded as an essential part of the Chinese version of a socialist market economy. Domestically, a framework for private enterprises was created with a new company law in 1994. The state sector of the economy was also modernised through the introduction of public corporations and the listing of a number of these companies on the newly created stock markets in Shenzhen and Shanghai. In 1999, the national constitution was amended to explicitly recognise private property rights.

But perhaps the most important factor for China's take-off has been its openness to foreign trade and investment. The economy was decisively opened by encouraging foreign investment, reducing effective tariffs on imported inputs (especially when used for export production) and abolishing multiple exchange rates and introducing convertibility for current account transactions. Non-tariffs barriers have been reduced too, but remain pervasive. The accession to the WTO in 2001 was a very decisive step, which placed China firmly on the world stage and provided an impetus and commitment for the reform process.

Box 2-2: Economic Impact of China's WTO accession

On 11 December 2001, China became the 143rd member of the World Trade Organisation, after over 15 years of negotiations. As a new member, China committed itself to ***a comprehensive package of trade and investment liberalisation***, phased in over a period of two to five to ten years. The major commitments were to reduce tariff and non-tariff restrictions[17]; limit farm subsidies[18]; provide full trading and distribution rights to foreign firms; liberalise the oil sector and open up its services sector.[19] In addition, the protocols of accession included signing up to the WTO's intellectual agreement on protection of patents, copyrights and trademarks, stipulations to increase the transparency of China's trade regime and procedures for the judicial review of administrative actions. It also requested state-owned enterprises to make their purchasing decisions on commercial grounds only. China's WTO partners, on the other hand, have undertaken to eliminate quotas on China's textile and clothing exports by 2005 (MFA), subject to special safeguard provisions through to 2008. It also maintains the anti-dumping methodology, treating China as a non-market economy, for 15 years after WTO accession.

On average, the ***ex ante predictions*** on effects from WTO accession were that after short term adjustment costs, WTO accession would in the long term be unambiguously positive for China's economy, adding a growth dividend of around 1.3% per annum.[20] On the cost side, short-term disruptions were expected from increased international competition in the form of rising bankruptcies and displaced workers. These costs are more concentrated in highly protected sectors, dominated by inefficiently run SOEs. Also China's agricultural producers are major losers from tariff and subsidy cuts. But also Telecommunications and Banking, in services, and Automobiles and Steel, in manufacturing,, were among the sectors expected to suffer most. On the benefit side, the long-term growth effects are more dispersed across sectors and agents. These benefits come from increased investment and competition, leading to higher overall productivity growth, particularly in those sectors where China holds a comparative advantage. At the macro-economic level, China's accession was expected initially to lead to a deterioration of its current account as imports grew. This should however improve again in the medium term, following China's restructuring effort. The capital account however was expected to be affected positively from increased inflows of FDI, such that the overall balance of payment was expected to increase after accession.

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17 e.g. average tariffs on non-agricultural products to be reduced over five years from 18.5% to 9.4%; on agricultural products from 20% to within the range 9-18%..

18 Spending on farm subsidies capped at 8.5% of the value of domestic farm production.

19 Banking, distribution/retail, insurance, securities, telecommunications. See Lehman Brothers (2002) for a full list.

20 Based on an average of some ten studies, including IMF & World Bank, see Lehman Brothers (2005).

01_2006_4142_txt_EN.indd 17 12-07-2007 10:43:10

Taking stock of China's ***performance ex post***, after WTO accession, the evidence shows a remarkable resilience on the part of the Chinese economy to absorb the short-term losses, with a persistent overall growth rate and steady unemployment rate since accession, as the following sections will demonstrate. China's WTO accession seems to have caused more havoc outside China, with the US and the EU reimposing quotas on some Chinese exports.

To date, implementation of China's WTO commitments has by and large remained on track, with the average (unweighted) tariff rate continuing to decline to 10% in 2005 and key commitments with respect to banking, trade and distribution rights having moved forward.[21]

That said, there are ***concerns*** among other WTO members that Non-Tariff Barriers remain high, resulting in effective market access remaining difficult for foreign companies, particularly in sectors which China has selected as "strategic", e.g. banking. Particularly, issues related to IPR, local procurement, local content regulations, local standard setting, registration and certification requirements and procedures, remain on the list of concerns (cf below)

There are also concerns that China is not yet properly playing a more constructive role in the Doha Round negotiations, in line with its growing economic importance. Having benefited greatly from trade liberalisation, it should now, being inside the system, accept responsibility for further pushing trade liberalisation globally.

The fixed exchange rate of the Renminbi and its role in the open-door policy to promote export–led growth has been the subject of intense debate. The Renminbi's value against the US dollar had been maintained at a fixed level since 1995. With effect from 2005, its value is set by reference to a basket of currencies. In practice, however, the Renminbi still appears to be pegged to the dollar, with little de facto flexibility. China's resistance to pressures for a substantial real exchange rate appreciation has fed speculative capital flows in anticipation of an eventual Renminbi appreciation. This in turn has led to a surge in the accumulation of international reserves in China (for more on the Renminbi's revaluation, see Part II).

2.2. The contribution of capital, labour and other factors to growth

This section assesses the contribution of the various input factors for growth, using a standard growth accounting framework. Investment, rather than private consumption, has been the main source of demand growth in China. A crucial factor driving the increase in GDP over the past two decades has been the accumulation of *capital*, as Table 2.1 clearly illustrates.[22] The contribution of capital represents around 5% of annual GDP growth over the period under consideration. Most of this capital spending comprises investment in fixed assets (capital construction),[23] reflecting the importance of the industrial sector to China's economic structure. Although government expenditures on infrastructure have been important,[24] the capital accumulation was financed for the most part by foreign investment and domestic personal sector savings. The investment boom in recent years has been fuelled by cheap credit. Households, saving for future purchases of education, health and housing, willingly hold bank deposits despite the weaknesses of the banking system, but because of implicit deposit insurance by the government. This provides abundant liquidity for banks to expand credit. Inflows of (speculative) capital

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21 Lehman Brothers (2005).

22 OECD (2005)

23 About half of GDP in the first six months of 2005 represented investments in fixed assets (Source: ITPS 2006).

24 Government expenditures on infrastructure have been substantial. In 2003, capital construction was the largest item, representing about 14% of total government expenditures (cf Part II for more on Government Expenditures).

01_2006_4142_txt_EN.indd 18 12-07-2007 10:43:11

have added to the liquidity in the banking system. Nevertheless, as will be detailed in Part II, inefficiencies in financial markets are seriously limiting the contribution capital can make to Chinese growth. Banks largely use their liquidity to finance investment by state-owned enterprises.

Table 2-2: Sources of output growth

	1983-1988	1989-1993	1993-1998	1998-2003
GDP growth	**12.1**	**8.9**	**9.8**	**8.0**
Employment contribution	1.5	1.0	0.2	0.3
Capital contribution	5.0	4.5	5.5	4.9
Residual factors	5.6	3.4	4.1	2.8
Of which:				
Sectoral Change	2.2	0.8	-0.3	0.5
Education	1.0	0.9	0.9	1.1
Multi Factor Productivity	2.4	1.7	3.4	1.3

Source: OECD (2005) All numbers Percentage points

The contribution to growth made by *employment,* on the other hand, has been very modest (<1% of GDP growth). Slowly decreasing labour participation rates, following on from the restructuring of the economy, particularly within the state-owned enterprises and the agricultural sector, as well as the expansion of education, are all factors in explaining the low employment component. The kind of labour market reforms needed to boost employment's contribution to growth will be detailed in Part II.

The crucial role of *human capital* as a determinant of national growth is undisputed. The increasing level of *education* of the labour force has contributed about 1% of GDP growth over the past two decades (see table). The positive growth effects of human capital are generated by boosting the skill levels of workers, equipping them to use new technologies and improving their adaptability. According to the World Bank Development Indicators 2006, China had, in 2004, about 70% of its population in the relevant age cohort enrolled in secondary schooling, 15% in tertiary schooling[25]. This is considerably higher than most developing counties, including India (with 52% and 11% respectively), but still considerably below most developed countries, particularly with regard to tertiary education (e.g. Germany has 100% and 50% respectively). China's

[25] The present education system was formed in the years between 1977 and 1980. Basic education extends over 12 years, divided between 6 years primary education and 6 years secondary education. China has 9 years compulsory education. The system is generally considered very competitive. English is taught at all levels, starting from junior middle school, but the result is mostly a passive language knowledge. Admission to all levels of education from high schools to PhD programmes takes place on the basis of performance in admission examinations. The most critical is the National College Entry Examination, which determines who gets access to higher education. In 2005, 8 million pupils competed for just over 4 million positions in higher vocational and undergraduate university education. In short, competition is fierce (NESO 2005).

01_2006_4142_txt_EN.indd 19 12-07-2007 10:43:11

leadership has understood the need for an educated and skilled workforce and has been stressing the role of education since the mid 1990s, particularly higher education. Overall financing of education increased from 2.8% of GDP in 1991 to 5.2% in 2002.[26] About 2/3 of this spending is public, while the remaining educational funds are generated by privately paid tuition fees and non-government funding organisations (Opper, 2005). Private education at all levels is a rapidly expanding industry in China. Though many private schools offer good educational value, such as better facilities, they rarely rank among the top schools in China.

The positive contribution of the *sectoral change component* reflects the shift out of the highly inefficient agriculture sector. The contribution of these sectoral reallocations to growth are however modest, particularly in the later periods, since the marginal workers leaving agriculture, and moving mostly into manufacturing, are much less productive than the average in the manufacturing sector, where they mostly move to, and the catching-up process is a slow one.

Box 2-3: China's Economic Structure

China's economic structure is strongly focused on the manufacturing sector, as the following table shows. The services sector is under-represented as compared to other developed countries. The agricultural sector is over-represented as compared to other developed countries, but on a par with the stratum of middle income countries.

Economic Structure, 2004 (added value, share of GDP)

	USA	EU-25	China
Agricultural	1.6	6.1	14.7
Industry	23.1	27.9	50.9
Tertiary	75.4	69.9	33.1

Source: World Bank indicator (2005)

China's agricultural sector

Although the agricultural sector accounts for only a minor and shrinking part of Chinese GDP, the majority of the population is still "rural". Beyond farm jobs, the rural labour force is also in non-farm jobs, notably in Township and Village Enterprises (TVEs), which are mostly privately owned. The decentralised rural fiscal structure has distorted investment away from agricultural development into these TVEs.

The Chinese government, concerned by food security and poverty reduction, needs to improve agricultural sector productivity. China's WTO membership and pressure on RMB appreciation are adding to the reform pressures, since cheaper agricultural imports are hurting China's heavily protected agricultural sector.

Fiscal reform is essential to re-energising the agricultural sector (cf below). Other policy instruments for improving agricultural productivity are technological and scientific developments, price reforms providing greater incentives to farmers, and land reform permitting private ownership of land.

The 11th five-year Programme (2006-2010) suggests that there should be more investment in rural infrastructure and agricultural technology, continued reduction of the tax burden on the countryside, improved rural public services (in particular education), a revitalised cooperative health system, and protection of farmers' land rights against unfair expropriations of their land. Farmers should be allowed freedom to sell or lease their land and there should be an end to restrictions on rural to urban migration. The Plan however never indicates clear concrete policies to implement these broad objectives. Thus it remains to be seen if and how it will be translated into action.

[26] Cf infra for more on public spending on (higher) education

01_2006_4142_txt_EN.indd 20 12-07-2007 10:43:11

Chinese manufacturing sector

China's economic structure remains focused on manufacturing. China's sectoral specialisation pattern is moving beyond the traditional low-tech sectors. As the following table clearly shows, in the list of major manufacturing industries, electronics and transport equipment are increasing their share in value added, while textiles and food & drink are declining (for more on the Chinese Manufacturing Sector and its evolving specialisation patterns, cf below).

China's services sector

China's service sector is, compared to other countries', relatively less developed. In 2004, services accounted for 33% of GDP.[27] This compares to around 75% for the US and 70% for EU-25. The service sector is generally difficult to define and measure. In China's case, the problem is even greater. All statistics on services should be interpreted with great care. In December 2005, China's official GDP figures were revised, leading to a 17% larger GDP for 2004. The bulk of the revision (90%) is due to the tertiary sector, and within service sectors, "transport & communication", "trade & catering" and "real estate" account for more than three-quarters of the revision. As a consequence, in the revised figures, services account for around 40% of GDP. However, even at the new revised figures, China's service sector remains a relatively small part of the economy compared with other countries.

The underdeveloped services sector has great potential for creating jobs. But much will depend on the will of the government to deregulate the sectors, introduce more competition and open it up to foreign participation, as stipulated in the WTO accession agreement (cf below).

China's Manufacturing Structure: Share of Value added of Major Industries

	2003	1998
Electronic & Telecom Equipment	9.5%	6.4%
Electric Equipment	5.2%	5.0%
Machinery	7.3%	7.7%
Chemicals (including pharma, rubber & plastics)	12.3%	12.3%
Food & Drink	7%	8%
Textiles, Clothing&Leather	8.8%	10%
Transport Equipment	6.9%	5.8%

Source: OECD (2005)

An important component of growth in output is *Total Factor Productivity* (TFP), the residual component in a growth accounting framework, which is typically associated with improvements in productivity and innovation. For China, the growth in TFP is mostly due to the rise of the private sector in the economy, with enhanced efficiency as a result. Section 2.3 will discuss the developments in the private sector. An important factor in the increase of TFP from the private sector is its opening-up to world markets, with both inflows of Foreign Direct Investment (FDI) and exports to world markets providing important gateways for catching up on productivity growth. This will be further detailed in section 2.4.

The slowdown in TFP growth in more recent years reflects a number of residual challenges, attributed to insufficient flexibility in labour, capital and product markets to stimulate productivity. This will be further examined in Part III.

2.3. The private sector

China's rise in the global economy today is driven by highly entrepreneurial forces in the private sector. Facilitated by an increasingly tolerant (but not always supportive) policy environment and reforms (cf section 2.1), private enterprises have outpaced public ones. Value added by privately controlled companies now represents at least half of all value added in the economy, as the following Table demonstrates.

[27] *Source*: World Bank Development Indicators 2005

01_2006_4142_txt_EN.indd 21 12-07-2007 10:43:11

Table 2-3: Private versus Public sector in the Chinese economy: % of value added by firm ownership

	1999	2001	2003
Private Sector	51.5	55.5	59.2
Public Sector	48.5	44.5	40.8
State-controlled	37.1	35.7	33.7
Collectively controlled	11.3	8.8	7.1
Total (100 % of GDP)	**100**	**100**	**100**

Source: OECD, 2005 (Economy wide)

Note: A considerable amount of uncertainty surrounds any estimates of the private sector in China due to the difficulty of determining which enterprises are controlled by private entities. The OECD uses a relatively strict definition of private enterprises: only firms that are not identified as being public-controlled (state or collective controlled) are classified as forming the private sector (OECD, 2005).

Private ownership has become widespread across industrial sectors. While in 1998, the private sector produced the majority of value added in only five industrial sectors, by 2003 this was true for all manufacturing industries.

Table 2-4: China's Manufacturing Structure: Share of Value added by Private Sector in Major Industries (2003)

Electronic & Telecom Equipment	*74%*
Electrical Equipment	*77%*
Machinery	*63%*
Chemicals (including pharmaceuticals, rubber & plastics)	*60%*
Food & Drink	*69%*
Textiles, Clothing & Leather	*82%*
Transport Equipment	*33%*

Source: OECD (2005)

With the exception of transport equipment, which is still mostly state-controlled, all the major sectors are mostly privately controlled. Beyond manufacturing, the state also remains dominant in mining and utilities. In service sectors the experience has been mixed. Distribution has also become increasingly private, but the penetration in other tertiary sectors – e.g. financial services – is lagging behind (see below).[28]

[28] Most services remain dominated by state monopolies in telecommunications, banking, health care, tourism, transportation, logistics, utilities and others. Due to the poor quality of the services statistics, in what follows, we will restrict the discussion to industrial sectors, unless otherwise stated.

01_2006_4142_txt_EN.indd 22 12-07-2007 10:43:12

The increasing share of the private sector has improved economic performance, as the private sector is more efficient than the state-controlled sector. According to OECD (2005), capital intensity in the private industrial sector is one-third that of the public industrial sector, but labour productivity is just 15% less. TFP in private sector companies, after taking into account the impact of firm size, location and industry affiliation, is double that in directly state-controlled firms. As a consequence of higher TFP and lower capital output ratios, the profitability of the private sector has been growing, despite increasing liberalisation and market competition. Along with profitability, private sector employment has been growing, offsetting the large and continuing decline in state sector employment.

One important factor to explain higher productivity is the private sector's openness to competition on world markets. Many private firms are engaged in processing imports, i.e. imports of inputs from abroad, which are used to produce goods for exports. But perhaps more important is the role played by Foreign Direct Investment in China. Foreign owned firms are not only characterised by higher productivity levels, they also stimulate productivity in local firms through technology spillovers and competition. Trade patterns will be examined in chapter 3. The next section will review the role of FDI in China's development.

2.4. Foreign Direct Investment

China's integration in the global division of labour has probably been the most important element of the recent economic development process. Foreign Direct Investment (FDI) was the catalyst to bring China's economy back onto the global stage. Initially, this FDI was mostly aimed at developing export oriented activities, with China benefiting from the import of capital, employment creation and exports, and from the modern technology brought in by the MNEs. Later, FDI become more motivated by market access. Currently, China is trading access to the Chinese market against foreign investors' technological and organisational know-how.

2.4.1. The political framework for FDI

In 1980, China created special economic zones which were isolated from the prevalent hierarchical system and allowed to adapt to fit into the world economy. Substantial amounts of FDI quickly found their way into these enclaves, foreign trade picked up and economic development took off. With the success of these first market-economy enclaves, more and more regions were permitted to experiment with institutions and institutional structures specifically designed to cater to the needs of international economic exchange.

Foreign firms enjoyed preferential treatment with regard to property rights security and taxes.[29] The level of property rights security granted to foreign firms in the 1982 constitution was only granted to private firms in 2004. At the moment, the official preferential treatment of foreign direct investment has been dismantled.

Under an export-oriented development strategy, foreign firms were initially prompted to export most of their production. Local content requirements were imposed to ensure positive spillovers on the local economy from FDI. However, with more liberal FDI

[29] Most foreign controlled companies pay a corporate tax rate on average of 21%, half that of domestic companies, OECD (2005)

01_2006_4142_txt_EN.indd 23 12-07-2007 10:43:12

regulations resulting in better access to the Chinese market, and rising purchasing power of (parts of) the Chinese population, the nature of FDI is gradually changing. "Market seeking" FDI is becoming more important and is expected to become the main mode of China-bound FDI.

There have been ongoing improvements in market access following China's WTO commitments. In 2004, the Ministry of Commerce issued new rules that liberalise access to the distribution services sector, and a new catalogue of encouraged, restricted, and prohibited sectors was published at the beginning of 2005, increasing the number of service sectors open to investment.[30] Moreover, restrictions on wholely foreign-owned enterprises (WFOE) have been relaxed. For instance, in the 2001 revision of the WFOE law, export requirements were dropped and technology transfer requirements were relaxed. Nevertheless, market access for FDI is far from complete. Current rules on public procurement continue to discriminate against foreign controlled companies established in China. Also, local standard setting (e.g. in mobile phones), slow business licence applications, opaque registration and certification procedures, and IPR issues continue to hamper foreign firms' access to the local Chinese market.[31] Although these remaining market access issues may simply reflect a still ongoing process of liberalisation, there is some concern in the West that some of these NTB issues are more "structural" in nature, reflecting China's increasing desire to rely on indigenous capacity rather than FDI.

2.4.2. FDI Inflows and the Modernisation of China's Industry

2.4.2.1.The FDI Booms

It was not until China's strong commitment to a market economy in the early 1990s that the country was able to attract substantial amounts of FDI.[32] The first "FDI boom" began in 1992[33] and came to a halt in the turmoil of the Asian crisis (see Table 1). A short period of consolidation was quickly followed by the take-off of the second "FDI boom" rooted in China's accession to the WTO in late 2001. Currently, China has become the first destination for FDI in the developing world, absorbing 20-25% of all FDI directed towards these countries (UNCTAD).[34]

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30 In some important (strategic) sectors, Joint Venture restrictions remain, such as (petro-)chemicals and car manufacturing.

31 For instance in the banking sector, despite the improvements in opening up this market in line with WTO commitments, the effective penetration of foreign banks remains very limited (cf below), attributed to Non-Tariff Barriers. For example, the size and the nature of liquidity and capital ratio requirements, as well as the restrictive licensing rules with regard to RMB transactions, reduce the attractiveness of FDI for foreign banks in China.

32 Such a wait-and-see attitude is consistent with the experience among other developing economies. Due to insufficient market information foreign investors delay their investment decisions until pioneer investors provide them with further insights into the market environment and the reliability of the host countries' FDI policies.

33 In 1992, the first year of substantial FDI inflows to China, FDI flows to South Korea and Chinese Taipei dropped by 31% and 51% respectively, thereby pointing at a considerable diversion effect in China's favour (UNCTAD). It should also be noted that the upswing of FDI inflows to China coincides with a general increase in FDI flows to developing countries. Average annual flows directed towards developing countries in 1990-1993 were double those of 1987-1989 (UNCTAD, 2003).

34 The outstanding position of China remains unchallenged even bearing in mind that part of the resources classified as inflowing FDI has in reality been "round-tripping" money, i.e. money that had

01_2006_4142_txt_EN.indd 24 12-07-2007 10:43:12

Table 2-5: Trends in China's Share in World FDI flows

	1985-1995	1997	1998	1999	2000	2001	2002
China	11.7	44.2	43.8	40.3	40.8	46.8	63.0
	(6.5%)	(9.3%)	(6.3%)	(3.7%)	(2.7%)	(8.7%)	(9.3%)
USA	44.4	103.4	174.4	283.4	300.9	124.4	63.0
	(25.5%)	(21.6%)	(25.1%)	(26.0%)	(20.2%)	(19.4%)	(9.3%)
World	**181.1**	**478.1**	**694.5**	**1088.3**	**1491.9**	**818.0**	**681.0**

Source: United Nations Conference on Trade and Development (Unctad).

In relative terms, the scale of the inflow of FDI for the Chinese economy has been large, amounting to 6% of GDP in the early 1990s, falling back to 3.5% since 2000 (although in absolute terms, the flows have continued to increase). The fall back in relative importance can be explained by the worldwide "recession" in FDI flows, cf above, but also by a shift in policy towards more reliance on domestic firms in selected sectors, like Information & Communication Technology (ICT) (cf below). It picked up again after 2000.

In China foreign firms have generated rates of return on FDI which are significantly higher than developing economies' average returns. One third of China's FDI inflows in 1999-2001 came from reinvested earnings.[35]

Figure: Rates of Return on FDI, 1999-2001

	1999	2000	2001
China	5.6	6.2	5.8
Hong Kong	13.6	12.5	11.5
Developing Economies Average	4.6	4.3	4.2
Developed Countries Average	7.4	7.1	5.7

Source: Unctad (2003).

Although the growth in total inflows of FDI into China has been impressive, a closer look at where the inflows are coming from (2.4.2.2) and where in China the flows are going to (2.4.2.3.) puts in perspective somewhat the importance of FDI for the overall development of the Chinese economy.

2.4.2.2. FDI inflows by country of origin

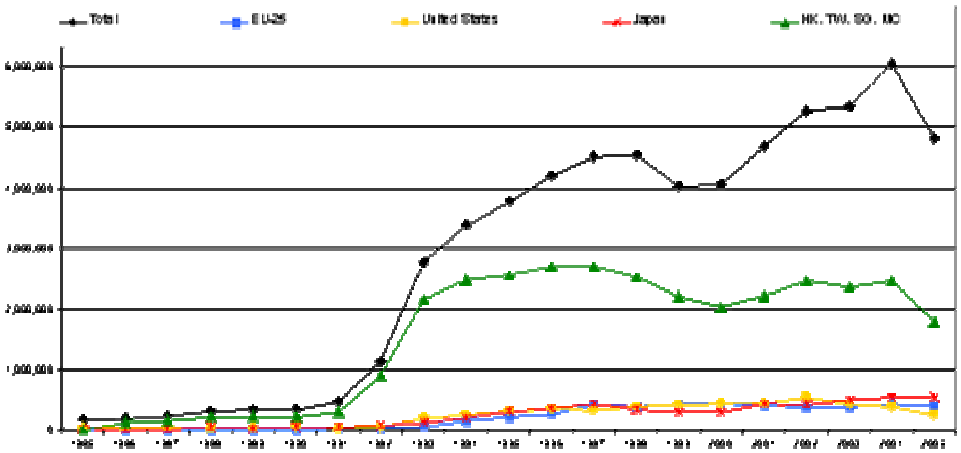
The bulk of China's massive FDI inflows have originated not in the world economy's centres of technological growth. The Triad economies of the EU, Japan and the USA have each accounted for only about 10% of all China-bound FDI. This means that the stock of Western investment is much lower than might have been expected.

been illegally brought out of the country in the first place and then brought back under the label "FDI" in order to benefit from special incentives reserved for foreign investment enterprises (cf below).

[35] UNCTAD (2003).

01_2006_4142_txt_EN.indd 25 12-07-2007 10:43:12

Figure 2-1: FDI into China by Country of Origin



Note: 2005 excluding November-December.
Source: Science Statistical Yearbook, various issues; adapted from Clegg (2005)

Hong Kong, Taiwan and South-East Asia have been the most important investors in China. Part of this investment is so-called "round-tripping" in search of preferential treatment,[36] which puts into perspective the use of FDI as a mechanism for importing technology. Nevertheless, a substantial and growing share of FDI into China, even from Hong Kong and Taiwan, is a source of technological know-how for the Chinese economy. The overwhelming majority of Hong Kong and Taiwan invested enterprises in China are engaged in export processing activities. Taking advantage of the complementarity of their respective resource endowments, Hong Kong and Taiwan have each established very close economic relations with China, transferring their labour intensive production facilities to the Chinese mainland, as the following Box details.

[36] Although it is difficult to measure exactly the share of round-tripping in China's FDI inflows, it accounts for a large proportion of China's FDI inflows coming from Hong Kong or overseas tax havens such as the British Virgin Islands, Bermuda and Cayman Islands. A 2002 report by the International Finance Corporation (IFC) of the World Bank put the estimates at 30-50% of the total in 2000. And the market's general assessment is that the ratio has declined from 30% to around 10-20% in recent years.

01_2006_4142_txt_EN.indd 26 12-07-2007 10:43:15

Box 2-4: The economic presence of Hong Kong and Taiwan on the mainland

Hong Kong

Hong Kong has established a pattern of economic interaction with China that is characterised by a very high degree of interdependence, de facto merging the Chinese Pearl River Delta and Hong Kong into a highly integrated economic region.[37] This economic nexus between China and Hong Kong, which in the 1980s and early 1990s primarily relied on individual entrepreneurial activity and was lacking a formal institutional framework, has in recent years been put on a sound institutional foundation. On 1 January 2004 the first stage of the Closer Economic Partnership Agreement (CEPA) between China and Hong Kong came into effect. From then on zero tariff rates applied for a large and expanding range of goods. In addition Hong Kong companies now benefit from deregulation in 18 service sectors going beyond China's final WTO commitments as well as current WTO phase-in requirements. These sectors include management consulting, convention services, advertising, accounting services, real estate and construction, medical and dental, distribution services, logistics, freight forwarding agency services, storage and warehousing services, transport services, tourism services, audiovisual services, legal services, banking, securities insurance and value-added telecommunication services.

Taiwan

There is no formal institutional foundation for economic interaction between China and Taiwan. Moreover, there are no direct transport, trade and postal links, although since 1997 ships have been allowed to sail directly between certain ports if they do not carry local cargo. Also, indirect sea links have been liberalised,. While the remaining restrictions are cumbersome and increase transaction costs, it is the restrictions on flows of capital and people that seriously prohibit deeper economic integration.

Nevertheless, since the late 1980s Taiwanese entrepreneurs have been moving to mainland China. Relying on informal arrangements and entrepreneurial savvy for circumventing government restrictions they have been transferring complete value-chain segments to mainland China in order to uphold their cost competitiveness on global markets. The business sector maintaining the closest links to mainland China is Taiwan's electronics industry. After concentrating their investments in Fujian province just north of Taiwan in the early stages of development, Taiwan's electronics companies have also established an electronics industry cluster in the Suzhou area (Jiangsu province) that builds on experience acquired in Taiwan's Taipei-Hsinchu electronics corridor.

Source: Adapted from European Commission (2005a).

2.4.2.3. Regional Distribution of FDI Inflows within China

The distribution of FDI within China differs widely between regions. FDI inflows have been heavily concentrated in the coastal provinces (the Eastern region), while the Central and Western regions have attracted only marginal shares.[38] About one third of China's total industrial output by all foreign firms is created in the province of Guangdong and another third in the Shanghai-Jiangsu-Zhejiang growth triangle (OECD, 2000, MOFCOM). The industrial output value of foreign funded enterprises, excluding those with capital from Hong Kong, Macao and Taiwan however, is first of all generated in the

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[37] The high intensity of economic interaction is facilitated by a fixed exchange rate between the Renminbi and the Hong Kong Dollar. With the HK$ pegged to the US$ at a rate of 7.8 to the dollar, and the Renminbi (at least in recent years) being de facto pegged at a rate of 8.28 to the dollar, the two currencies are upholding a fixed exchange rate to each other. Due to this triangular relationship any changes in the exchange rate between the Renminbi and the US$ must have a non-trivial impact either on the exchange rate regime of Hong Kong or on relative prices, i.e. on the structure of economic interaction between China and Hong Kong.

[38] Furthermore, there is no sign of diminishing regional disparities. In 2003, 89% of FDI into China still went into the Coastal Region, and only 8% into the Central Region, and 3% in the Western Provinces, Clegg (2005).

01_2006_4142_txt_EN.indd 27 12-07-2007 10:43:16

triangle, which accounts for nearly 40% of the total.[39] The high and persistent concentration of FDI in the coastal region is an important factor contributing to the persistent regional income disparities within China, and will be further discussed in part II.[40]

2.4.2.4. FDI inflows by sectoral affiliation

The distribution of China's FDI inflows to various sectors does not follow market parameters alone, but remains quite heavily regulated by the Chinese government. The "Foreign Investment Industrial Guidance Catalogue" outlines in which industries foreign investors are welcome, restricted or not permitted. Today, FDI excluded or restricted sectors include financial services, air transport, media and electricity.

As documented in the following table, foreign firms have a strong presence in the production of electronic and telecommunication equipment, office machinery, leather and sports goods, furniture, garments and plastic products. These goods are produced in predominantly labour-intensive production processes.

Table 2-6: Share of Foreign Enterprises in China's Industrial Production Gross Industrial Output Value by Sector 2003

	Share
Electronic and Telecommunications Equipment	73.4%
Instruments, Meters, Office Machinery	61.8%
Leather, Furs, and Related Products	53.2%
Furniture Manufacturing	47.3%
Garments and Other Fibre Products	45.3%
Plastic Products	41.9%
Food Manufacturing	39.6%
Rubber Products	36.6%
Metal Products	35.9%
Electric Equipment and Machinery	33.1%
Transport Equipment	31.8%
Beverage Manufacturing	30.2%
Textile Industry	22.1%
Raw Chemical Materials and Chemical Products	22.1%
Medical and Pharmaceutical Products	22.1%

Source: European Commission (2005a).

FDI into China is strongly concentrated in manufacturing. Although the inflows of foreign funds are beginning to shift into service sectors, in 2003 64% were nevertheless invested in manufacturing and only 23% in services, of which half is accounted for by real estate management.[41] This low share of services is mainly due to a policy bias that

[39] On the provincial level Guangdong seems to be in a class of its own. During the 1980s Guangdong absorbed nearly half of all the FDI China attracted during this period. In Guangdong itself FDI has been highly concentrated in a few localities (i.e. the Pearl River Delta and the Shantou area). In Guangdong enterprises with capital from Hong Kong, Macao, Taiwan generate nearly 50% of their industrial output value in Guangdong, while foreign firms generate only 20% of their national total in Guangdong.

[40] The persistence of FDI concentration is partly explained by agglomeration economics. New FDI prefers to locate close to existing FDI to benefit from externalities, such as joint infrastructure, networks of suppliers and customers, etc.

[41] China Statistical Yearbook (2004).

01_2006_4142_txt_EN.indd 28 12-07-2007 10:43:16

promoted foreign investment in traditional industries, while restricting foreign participation in services. Foreign ownership in banking is expected to increase after 2005, depending on how swiftly market access barriers are lifted.[42] In other service sectors like telecommunications and securities, foreign participation is more likely to remain limited.

Table 2-8 indicates that the top two sectors with respect to FDI are ICT sectors. The next section will examine in more detail ICT and more generally Chinese High-Tech Manufacturing and the contribution of FDI towards growth in these sectors.

2.5. China's high-tech industries and the role of FDI

China's economic policymakers are aware that China being the global centre for labour intensive, low skilled manufacturing will not be sufficient to sustain growth performance in the longer term. While industries establishing labour intensive production capacities in China are important, as they create jobs for China's population and facilitate the task of economic restructuring, the current focus of China's industrial policy is on promoting and establishing higher value added, technology intensive industries.

China's high-tech industries still lag behind those of developed countries, but they are growing rapidly. Their contribution to manufacturing value added increased from 6.2% to 9.3% over the period 1995-2000, still very much below US values (21%), but coming close to Italy (9%), Germany (11%) and France (14%).[43]

High-tech sectors are contributing substantially to the strong growth performance. These sectors typically have a higher productivity than other sectors, related to higher R&D investments. For China, R&D expenditures as a share of value-added in high-tech industries was 2.4% in 1996, increasing to 4.4% in 2003. In the electronic and telecom sector the R&D-to-value-added ratio is 5.4%. This is still below international levels in these sectors, but catching up.

The growth in China's high-tech has a strong international dimension. China has been a prolific importer of technology embodied in goods.[44] It has been less active as an importer of disembodied technology, which entails royalty or other licensing fees.[45] The most important mechanism used by the Chinese government to bring in foreign technological know-how is by encouraging foreign investment in high-tech sectors. As a consequence, foreign-owned firms now play an important role in Chinese high-tech industries, accounting for more than half of total high-tech firms. Nevertheless, there are substantial differences across the various industries. Foreign presence is particularly high in computers and office equipment and in electronic and telecom equipment, not so much in air and spacecraft and pharmaceuticals.

The entry and presence of foreign firms bring China not only production facilities but also R&D sources, as reflected in the R&D expenditures by foreign-owned firms. Foreign firms are quite active in R&D in some high-tech sectors, such as computers and

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[42] Under the WTO accession agreement, foreign banks are allowed to take a 20% ownership in local banks, conditional on not exceeding 25% total foreign participation.

[43] The OECD classifies as high-tech industries Air & Spacecraft (353), Pharmaceuticals (2423), Office machinery (30), Radio, TV & communication equipment (32), Instruments (33).

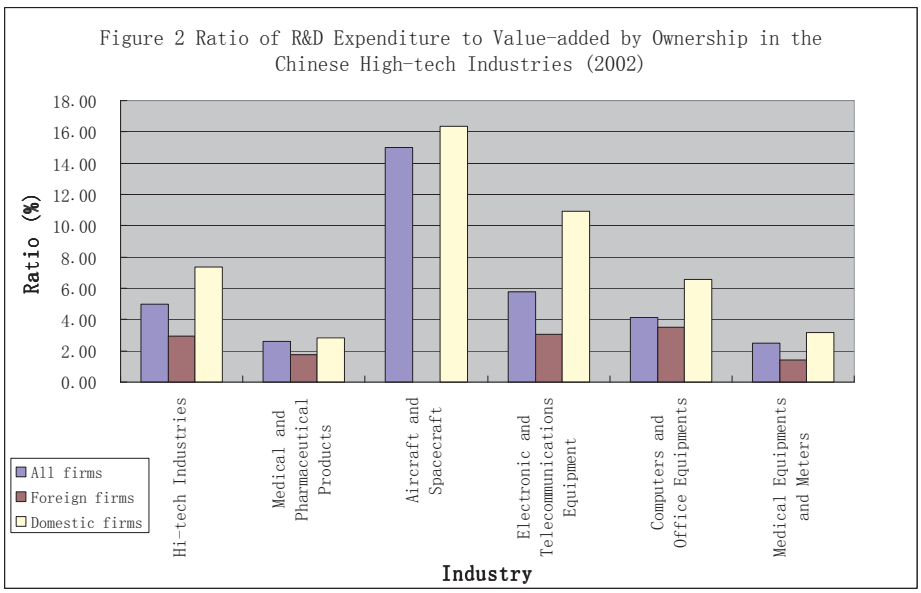
[44] High-Tech imports accounted for about 30% of total Chinese imports in 2003.

[45] China spends about 12% of what Korea spends as a share of GDP on licensing foreign technology (World Bank (2002)).

01_2006_4142_txt_EN.indd 29 12-07-2007 10:43:16

electronics. Nevertheless, domestic firms are the major players in terms of R&D input in China's high-tech industries. The R&D intensity (R&D expenditure to value-added ratio) of foreign firms is only about half of that of domestic firms (See figure 2.2). This low level of foreign R&D puts into perspective the use of FDI by China as a mechanism to get access to foreign technology[46] This can be correlated to a reluctance on the part of American, European and Japanese firms to locate R&D in China. Under unclear IPR regimes, when it is difficult to keep know-how proprietary, foreign firms will prefer to leave most of their core R&D at home when locating in China.

Figure 2-2: Ratio of R&D expenditure to Value-added by Ownership



Source: Guo & Veugelers (2005)

Nevertheless, foreign firms from high-tech industries increasingly (have plans to) locate R&D in China. Although the exact number of these foreign R&D centres is not clear, the evidence suggests that they are increasing rapidly. For example, US outward R&D investment in China has grown by 25% annually since the mid 1990s (against 8% per year in EU-15), making it the fastest growing destination for outward R&D investment.[47] Survey data on FDI intentions further indicate that China is high on the list of planned R&D investments. For example, a global survey conducted by the Economist Intelligence Unit in 2004 showed that top companies' favourite location for planned R&D investment was China, followed by the US and India. UNCTAD has also found

[46] Indeed, Guo & Veugelers (2005) find no evidence of positive spillovers from R&D-FDI on local Chinese firms' productivity.

[47] In addition, patents owned by US assignees but invented abroad, although only 12% of total USPTO patents, are the fastest growing component of US patents. In these foreign invented US patents, the EU is still the biggest destination, but Asia (excl Japan) is the fastest growing component of foreign invented US patents (R&T Management (2005)).

01_2006_4142_txt_EN.indd 30 12-07-2007 10:43:17

that while the US is the top destination in developed markets, China is a top destination among developing countries.[48]

Due to recent WTO-related reforms, foreign high-tech enterprises are now in many cases allowed to establish wholely foreign-owned subsidiaries in China, which are more attractive than joint ventures for conducting R&D, since they are more effective at keeping core know-how proprietary. This is of particular relevance in China, given its weak enforcement of intellectual property rights. Hence, foreign firms are currently consolidating their earlier research-related programs into whole-owned subsidiaries while simultaneously shifting toward more advanced R&D activities.

Locating R&D in China is motivated by the need to be close to the large (potential) Chinese market. But also access to the local base of Science & Technology know-how — , particularly, the large pool of engineers and scientists — is a major pull-factor for attracting foreign R&D investments.

2.6. China's Science & Technology

Initially China's development was focused on importing foreign technology and capital through FDI, allowing China to catch up quickly. These foreign firms were exporting most of their production to the world market. More recently, however, with a more developed and growing internal market and having moved closer to the technology frontier in a number of sectors, most notably in ICT, China has embarked on a new phase of development, relying increasingly on indigenous productive capacity. As Chinese enterprises get closer to the world frontier, being globally competitive will require investing more in R&D, not only to scan for, acquire and adapt foreign technology, but also to develop their own R&D capabilities in core areas of activity.

2.6.1. China's striving for S&T development

The importance the Chinese authorities attach to innovation is unprecedented. President Hu stated at the National S&T Conference in Beijing in January 2005 that the goal was to transform China into a nation of innovation in 15 years. This section will evaluate how far China has already progressed with regard to its own indigenous innovative potential. The challenges China is still facing reaching achieving this objective will be discussed in Part II.

China's Science & Technology base has grown rapidly, as illustrated by the following table. With a real annual growth rate in R&D expenditures of more than 15% per year, despite the strong growth in Chinese GDP, gross expenditures on R&D (GERD) as a share of GDP have increased from 0.7% in 1998 to 1.3% in 2003. This compares to 1.9% in the EU-25 in 2003[49] and 2.6% in US. If these trends in the EU and China continue, China will be spending the same amount of GDP on research as the EU in 2010 – about 2.2%.

Table 2-7: Some S&T input indicators for China

	1998	1999	2000	2001	2002	2003
GERD as % of GDP	0.7	0.83	1.00	1.07	1.22	1.31
Real annual growth (%)	10.9	20.3	16.9	15.0	23.8	17.2

Source: Science Technology Statistics, China

[48] Unctad (2005).

[49] This is already higher than Spain 1.05%, Italy 1.14%, Ireland 1.16%, but still lower than UK 1.9%, France 2.2%, Germany 2.5% (Source: Eurostat)

01_2006_4142_txt_EN.indd 31 12-07-2007 10:43:17

Enterprises accounted for 62.4% of GERD in 2003, while 26% is done by R&D institutions, and 10.5% at Higher Education institutions. Not surprisingly, high-tech manufacturing and particularly ICT takes up the bulk of Chinese business R&D investments: R&D expenditures in electronic and telecom account for 62.3% of total R&D in China 2003, computer equipment for another 11.5%. The pharmaceutical sector only accounts for 12.5%.

In line with overall Chinese development, R&D investments are heavily regionally concentrated. The top five Regions (Beijing, Guangdong, Jiangsu, Shanghai and Shandong) account for 53% of total expenditures on R&D, with Beijing accounting for 17% of GERD2003.

Although industrial investment in R&D is important and growing, the Chinese government remains an important financer of research. The next two sections will focus on government investment in S&T programmes (2.6.2) and on development of human capital (2.6.3) as major drivers of China's S&T growth trajectory.

2.6.2. Government funding of S&T

China's public investment in S&T represents 4% of total government expenditures (975.5 million Yuan) and 0.8% of Chinese GDP in 2003. The Chinese government funds R&D through five major programmes, most of which were established in the 1980s. Government funding is concentrated on specific fields selected for their potential contribution to China's development, such as IT, energy, biotech, along with national security (aerospace and laser) and fundamental science & frontier research, as the following Box documents. Each of the programmes supports a close science-business interface in order to secure innovation activities with good prospects for productivity growth and to maximise the commercialisation of R&D output.

Box 2-5: Major Chinese Government R&D Funding Programmes

The *Key Technologies R&D Programme*, the most important one in terms of total funding, was launched in 1982. It covers agriculture, electronic information, energy resources, transportation, materials, resources exploration, environmental protection, medical and health care, and other fields. It is the largest national programme and funds research at more than 1000 scientific research institutions.

The *863 Programme*, having started in 1986, looks at 20 areas selected for their high potential to contribute to industrial development. It includes space flight, laser, automation, energy, new materials, and marine.

The *973 Programme* is directed at basic research and began in 1998. It represents China's increasing support for basic knowledge creation and focuses on interdisciplinary scientific research in areas such as agriculture, energy, information, environment and resources, population and health and materials.

The *Torch Programme* is aimed at developing high-tech industries and was launched in 1988[50]. It is product oriented and includes the establishment of high-tech industrial development zones, the stimulation of funding by banks and the development of management skills among technical personnel. The projects centre on emerging fields such as new materials, biotechnology, electronic information, integrative mechanical-electrical technology, and advanced and energy-saving technologies.

[50] Legend/Lenovo is one of the examples of firms having benefited from the Torch Programme.

01_2006_4142_txt_EN.indd 32 12-07-2007 10:43:17

The *Spark Programme* began in 1986 and is aimed at revitalising the rural economy through science and technology. It includes mostly demonstration projects.

Beyond merely increasing spending, China has also improved the efficiency of its investments in public R&D. While initially the allocation of funds was exclusively top-down government led, the procedure for allocating S&T funds was replaced in 1985 by public competition and peer review, with the potential for the commercialisation of S&T output as a major criterion for funding decisions. Also universities and public research institutes have been reformed to increase their R&D efficiency (for more on this, see part II, Chapter 9).

2.6.3. Human Capital for S&T: tertiary education

An important component of S&T growth in China is its huge pool of human capital for R&D. This is an important attractor for enterprises (both local and foreign) and research institutes for investing in R&D activities in China. Scientists & Engineers (S&E), active in R&D have increased rapidly. China now has the second highest number of researchers in the world (18% of total world stock), still behind the US (23%), but ahead of Japan (14%)[51].

Table 2-8: Human Capital for S&T input indicators for China

	1998	1999	2000	2001	2002	2003
R&D Personnel (1000 FTEs)	755	822	922	956	1035	1095
S&E (1000 FTEs)	485	531	695	742	811	862
S&E engaged in R&D per 10000 labour force	6.7	7.3	9.4	10	10.8	11.3

Note: FTE=Full Time Equivalent

Source: Science Technology Statistics, China

Stimulated by increased funding and reforms in the higher education system, which took off in the main only in the late 1990s, the number of new students in the higher education system increased over tenfold between 1978 and 2004, but with the biggest rise after 2000. Yearly intake in the period 2000-2004 was 10 times higher than in 1978-1999. In addition, success rates have increased and further boosted the number of graduates and post-graduate students. As a consequence average yearly intake in graduate and post-graduate programmes increased tenfold after 2000 (Shichor (2006)). While according to World Bank Development Indicators, China had in 2004 about 15% of the relevant age cohort enrolled in tertiary education, the long-term plan is to increase the entrance rate of the age cohort (19-21) into higher education to 55% in 2050 and to increase the share of higher education in the workforce to 44% in 2050 (Chinese Education and Society (2005)).

Due to China's centralised system of university entry exams, the structural composition of university graduates can be closely aligned to the specific needs of China's economic development. In 2004, the majority of China's postgraduate students were in either engineering (39%) or science (12.5%). This makes China a top producer of engineers worldwide, along with the US. China is considerably weaker in social sciences and law.

China's revolution in higher education reflects large-scale investment. In 2004 most higher education funds came directly from the central government (nearly 47%).

[51] Research & Technology Management (2005)

01_2006_4142_txt_EN.indd 33 12-07-2007 10:43:17

Nevertheless, nearly 30% of higher education funding came from tuition fees, a remarkable high percentage, particularly for a socialist market economy.

To meet the huge demand for higher education, the Chinese government supports non-state/private entities in setting up and running educational institutions.[52] These private institutions, usually located in provincial urban areas, derive revenues from tuition and offer a limited range of professional courses and programmes. At present there are 214 private institutions of higher education, mostly offering vocational education. Only a handful offer Bachelor degrees. To ensure that all students, including the poor, have access to higher education, the Chinese governments, universities and banks have set up special financial support systems for poor students, which include scholarships, loans and tuition waivers.[53]

In a similar fashion, the Chinese government encourages foreign higher education providers to set up shop in China.

Box 2-6: Foreign Providers of Higher Education

Foreign universities are seen by the Chinese as contributing to the expansion of the domestic higher education capacity, providing an opportunity to attract modern and advanced teaching methods and curricula, as well as expertise in management of higher education institutes. Nevertheless, the activities and involvement of foreign universities in the Chinese education market are strictly regulated, e.g. the 2004 "Implementation Guidelines for the Provisional Regulations regarding the Sino foreign Joint Running of Schools". For instance, foreign providers are not allowed to operate independently; they may only offer their programmes in cooperation with recognised Chinese institutions. The vast majority of active foreign universities in China are from the US, Canada, Australia and the UK. Continental European universities account for only a very small portion of foreign programmes on offer in China (NESO, 2005).

The growth of the Chinese S&E base has been accompanied by a series of measures and policies designed to foster the *international mobility of human resources in Science & Technology*. The Chinese government greatly encourages international cooperation and exchange, including student mobility.

According to Statistics from the China Scholarship Council, between 1978 and 2004, 814 884 Chinese students went abroad for studies. 197 884 (i.e. almost 25%) have now returned. The number of students going abroad has skyrocketed particularly since the end of the 1990s. In 2004, about 115 000 students left the country to take up studies overseas. More than 90% self-financed their foreign studies. A prime destination for Chinese students is the US. According to the OECD (Educational Database), about 35% of the total number of Chinese students enrolled in OECD countries study in the US. The EU-based share has been growing and in 2002 accounted for 23% of total Chinese students studying abroad, similar to Japan's share.[54]

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[52] In addition, self-study is an important alternative for China's ambitious but constrained young people to move up (World Bank (2002)).

[53] In 1994, tuition fees were introduced at public and private universities. At present, tuition fees for public universities can be up to 10000 RMB, and up to 30000 RMB in private universities, depending on the discipline (NESO 2005).

[54] According to NSF (2004), Science & Engineering Indicators, in 2001, the group with the highest growth rate in degrees awarded in the US was Chinese students. They accounted for 7600 new PhDs in S&E in 2001 (compared to 118 000 to US citizens).

01_2006_4142_txt_EN.indd 34 12-07-2007 10:43:18

Box 2-7: China's participation in Erasmus Mundus exchange of students and scholars

The *Erasmus Mundus* Programme was launched by the European Commission in 2004 to foster co-operation and mobility programmes in the field of Higher Education and to promote the EU as a centre of excellence in learning. It provides, inter alia, scholarships for third country nationals, as well as scholarships for EU nationals studying in third countries. The 808 students selected in 2005-2006 come from 92 different countries, with China ranking second, after India (N=85). Of the 133 scholars selected, China accounts for 23, second after the US. This represented a big increase over the previous year, partly due to the "Asian Window" earmarking since 2005.

Source: DG EAC, *Erasmus Mundus* website

Despite the massive growth in numbers of outgoing students, the number of students returning to China grew even faster. For example, in 2004 25 000 students and researchers returned from foreign countries. To increase the return rate of students, government institutions[55] offer positions, funding and preferential tax treatment for overseas talent to come back and work in China. The Ministry of Education is setting up entire science parks and incubators where returned students and scholars are encouraged to set up shop under very favourable conditions (NESO 2005).

While the growth rate of Chinese students going abroad has recently been slowing down, doctoral S&E degrees earned by Chinese nationals at Chinese universities have grown considerably and have since 1994 surpassed the number at US universities (NSF (2004)). At the same time, more and more foreign students are coming to study in Chinese universities, mostly from Asia (South Korea, Japan, and Taiwan) and Africa. In 2004 there were 110 000 foreign students in China. All this reflects the increasing attractiveness of the Chinese Higher Education institutions.

2.6.4. China's S&T performance

The growth in R&D inputs (both funding and human capital) translates into a growth in S&T output, as measured by publications and patents. With respect to scientific papers, while China accounted for 1% of total SCI publications in 1991, it moved to 6.4% of total SCI publications in 2004, occupying fifth place in the world, ahead of France and Italy. There is however less growth in impact, as their share in citations indicates.

[55] The Chinese National Natural Science Foundation offers research positions and funding for returning junior faculty members. Also Chinese Science Academy's One Hundred Talent Project provides funding for overseas talent to come back and work in China.

01_2006_4142_txt_EN.indd 35 12-07-2007 10:43:18

Table 2-9: Publications and Citations by country

Country	Rank '04	1991		2002		2004
		Publications	Citations	Publications	Citations	Publications
USA	1	35.64%	53.61%	31.33%	47.33%	30.98%
Japan	2	7.64%	7.44%	9.21%	8.72%	8.67%
UK	3	8.59%	10.09%	8.69%	11.66%	8.43%
Germany	4	7.35%	7.81%	8.40%	10.53%	8.10%
PR China	***5***	***1.22%***	***0.50%***	***4.88%***	***2.92%***	***6.41%***
France	6	5.46%	5.91%	5.96%	6.81%	5.75%
Italy	7	3.07%	3.02%	4.29%	4.95%	4.48%
Canada	8	4.67%	5.00%	4.20%	5.19%	4.34%
Spain	9	1.75%	1.30%	3.15%	3.04%	3.26%
Russia	10	:	:	3.20%	1.47%	2.88%

Source: SOO Statistics, KU Leuven

With respect to patents too, China has displayed strong growth performance, not only in Chinese patents (SIPO), but also in Triadic patents. Nevertheless, although the growth is strong, its position is still very modest; China accounting for only 1.4% of all world patent applications. In 2003 China has 370 patents granted in USPTO compared to, for instance, 35 500 for Japan. Furthermore, Chinese international patent applications are dominated to a greater extent by foreign companies than in other countries. Between 1999 and 2001, almost half of all Chinese inventions were foreign owned, compared with only around 10% for the US or EU-25.

Table 2-10: International Patent Applications (number and share)

	1999		2004	
China	277	0.36%	1708	1.4%
EPC	30557	40.0%	43909	35.9%
India	101	0.13%	724	0.59%
Japan	7473	9.8%	20186	16.5%
USA	31255	40.9%	43400	35.5%

Source: WIPO, 2005 (EPC= 30 European countries belonging to the European Patent Convention)

Overall, while the Western economies are still struggling with the consequences of China's entry into the world markets as a major supplier of labour-intensive products, China has clearly embarked on a far more ambitious development trajectory of its own S&T base. Although it is still at a low base, China has managed to put in a remarkable growth performance in Science and Technology, supported by a targeted government policy. Linking to international S&T, by attracting foreign R&D and by stimulating international mobility of students, is seen as a key component of its strategy to further develop its own indigenous S&T capacity. Opinions on the sustainability of its S&T growth and capacity to acquire technological leadership are diverse. This will be further examined in Part II.

01_2006_4142_txt_EN.indd 36 12-07-2007 10:43:18

2.7. Conclusion

China's growth performance has been extraordinary since the start of economic reforms and of the opening up process. The Chinese case provides persuasive evidence that increasing openness to foreign trade and investment can lead to faster growth when coupled with complementary reforms to enhance the domestic economy. As the Chinese economy has gradually opened, it has become increasingly receptive to signals emanating from the global economy.[56] It has gradually reorganised in such a way as to bring its specific factor endowments into full play through a reform of its public sector and a growing private sector. FDI inflows have supported the creation of new factories and jobs, boosted export growth and led to important transfers of capital and technologies. The importance of inward FDI for Chinese development is however gradually declining as institutions improve, as the gap with foreign markets closes and in response to the industrial policy choice of the Chinese government to rely more on local firms and develop of indigenous know-how, at least in well targeted sectors.

Nevertheless, China is currently still relying to a large extent on wealth and knowledge provided by partners in the world economy. The next chapter will therefore assess China's current position in the world economy and notably its influence on world trade and investment patterns.

[56] On the downside China has also become more sensitive to external shocks emanating from the world economy. Today, the triad economies' business cycle development does have a distinct impact on China's economy. China remains, however, somewhat isolated from external shocks transmitted by the forex markets. The Renminbi is still not convertible on the capital account and enables China to isolate its fragile financial system from shocks like the "Asian crisis".

01_2006_4142_txt_EN.indd 37 12-07-2007 10:43:18

Box 2-8: The globalisation experiences of China and India compared

China and India are often cited as two success stories of globalisation. Both have enjoyed rapid growth alongside increasing integration into the global economy. However, their individual experiences have differed greatly, with each exhibiting its own model of economic development. China has relied on FDI and exports in manufacturing as a key anchor for its sustained acceleration in growth and integration. Globalisation has benefited India most visibly by supporting the rapid development of the service sector, which is now a key engine of growth in the Indian economy. If success is viewed in terms of accelerating GDP growth, the growth of GDP per capita, an increasing share of global trade, and the magnitude of FDI inflows, China would appear to have been more successful than India in all areas (see table).

The movement from autarky to international economic integration began in both countries following the failure of self-sufficiency policies in the 1970s. Compared to China's reforms outlined above, reforms in India towards industrialisation were undertaken more gradually, and external liberalisation started later than in China, triggered primarily by a balance of payments crisis in 1991. Prior to the crisis, India had been reforming with a view to enhancing the competitiveness of domestic industry, while maintaining protection against foreign competition. It has been asserted that pro-business reforms in the 1980s were crucial to raising the profitability of domestic industry, setting the scene for pro-market reforms in the 1990s (Rodrik, Subramanian; Panagariya).

The slower global integration of India compared to China is often attributed to the government's relative tardiness in removing external barriers to trade and investment. In India, reforms were also geared towards further opening the economy to trade and investment, including the dismantling of import controls, reducing customs duties, abolishing licence controls on private investment, lowering tax rates, breaking up public sector monopolies, and rupee devaluation. But only in the 1990s was tariff reform addressed more systematically. The 1990s saw a compression of tariff rates, with the top rate falling from 355% in 1990 to 20% by 2004. India's FDI regime has been gradually liberalised since 1991, and is no longer particularly restrictive by international standards. Therefore, the cause for the underperformance of FDI in India relative to China may not simply be rooted in FDI-specific policies, but rather in broader business climate factors (IMF 2005c). The Global Competitiveness Report 2004 of the World Economic Forum suggests that inadequate infrastructure, bureaucracy, corruption and restrictive labour regulations are among the key constraints to doing business in India.

A key factor behind the different responses to globalisation has been the policies undertaken to promote the manufacturing/service sector in each country, and the importance of investment in these sectors. China implemented industrial reforms at a faster pace than India. In India, there has been a lack of systematic reform in the agricultural sector, set against a slower pace of industrial reform. Industry remains constrained, notably by inadequate infrastructure, high indirect tax rates, and labour market rigidities, which deter job creation in the formal sector. Significantly slower industrial growth has reflected declining investment, concentrated in manufacturing and agriculture. The investment decline is partly due to fiscal crowding out, with large fiscal deficits for several years. On the other hand, the Indian service sector has performed extremely well, in particular the business (including IT) and communication sectors. Factors that could explain the relatively stronger performance of the services sector in India include: more generous tax incentives relative to the industrial sector; the liberalisation of financial services; and reforms in the 1990s, notably including the opening up of telecoms, which enabled a reduction in prices of telecom services and supported increasing external demand for IT services. Labour restrictions and infrastructure constraints may also have disadvantaged industry more than services. While India trails China in terms of primary and secondary education, it has achieved better scores in higher education, resulting in a large number of English-speaking highly-skilled graduates, something which has also supported growth in the IT-sector.

01_2006_4142_txt_EN.indd 38 12-07-2007 10:43:19

China and India compared

	1990		2003	
	India	China	India	China
GDP growth (81-90; 91-2003)	5.8	9.3	5.6	9.7
GDP per capita, PPP, current USD	1380	1310	2670	4580
Share of world GDP (nominal)	1.4	1.7	1.6	3.9
Share of world trade (%)	0.6	1.7	0.9	5.6
Gross domestic savings (% GDP)	23.1	39.0	24.2	42.7
Gross domestic capital formation (% GDP)	26.3	34.7	23.3	44.4
FDI inflows (bn USD)	0.2	3.5	4.3	53.5
Share of agriculture (% GDP)	32	27	22	15
Share of industry (% GDP)	28	42	27	52
Share of services (% GDP)	41	31	51	33

Source: EC-DG Ecfin

01_2006_4142_txt_EN.indd 39 12-07-2007 10:43:19

3. CHINA'S POSITION IN THE WORLD ECONOMY

As China has gradually integrated the world economy, its economic weight has been felt by other participants. China's impact on the world economy has been accentuated due to an increasing degree of openness to trade and FDI.[57] As a consequence, the volume of Chinese exports of goods and services was exceeded only by the US and Germany, despite these countries being much larger economies. Moreover, China is currently the third largest importer in the world (ahead of France and the UK, but behind the US and Germany).

Table 3-1: Share in World Merchandise Trade by Region, 2004

	Export				Import		
	Rank	(USD billion)	(%)		Rank	(USD billion)	(%)
Germany	1	912.3	10.0	United States	1	1525.5	16.1
United States	2	818.8	8.9	Germany	2	716.9	7.6
China	3	593.3	6.5	China	3	561.2	5.9
Japan	4	565.8	6.2	France	4	465.5	4.9
France	5	448.7	4.9	United Kingdom	5	463.5	4.9
Netherlands	6	358.2	3.9	Japan	6	454.5	4.8
Italy	7	349.2	3.8	Italy	7	351.0	3.7
United Kingdom	8	346.9	3.8	Netherlands	8	319.3	3.4
Canada	9	316.5	3.5	Belgium	9	285.5	3.0
Belgium	10	306.5	3.3	Canada	10	279.8	2.9
Hong Kong, China	11	265.5	2.9	Hong Kong, China	11	272.9	2.9

Source: World trade in 2004, WTO.

The position of China in world export markets is discussed in section 3.1, while the impact of China on world imports and prices of intermediate goods is discussed in section 3.3. With respect to FDI, the previous chapter already documented the importance of China as a destination of FDI. However, as with indigenous industry development, China is also increasingly a source of outward FDI and this will be documented in section 3.2.

3.1. China's position in Global Trade

China has become a major trading nation in the world economy. OECD estimates suggest that by the beginning of 2010 Chinese exports may overtake those of the US and may represent 10% of world trade at that point.

[57] Trade amounted to 35% of China's GDP in 2004.

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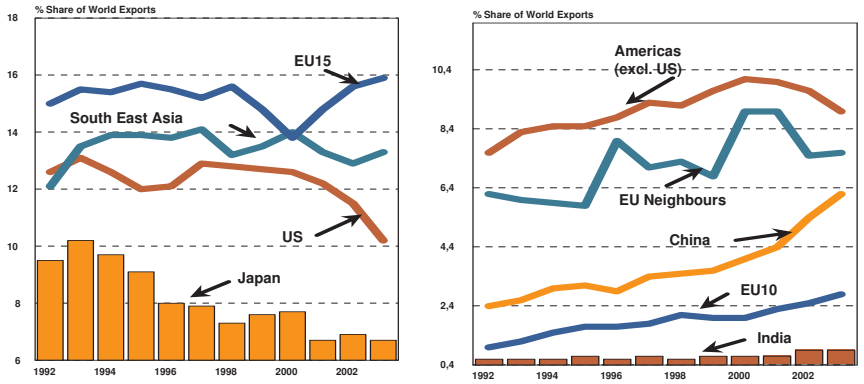
Figure 3-1: World export market shares for different countries/country groupings (manufacturing)



Source: European Commission (2005b).

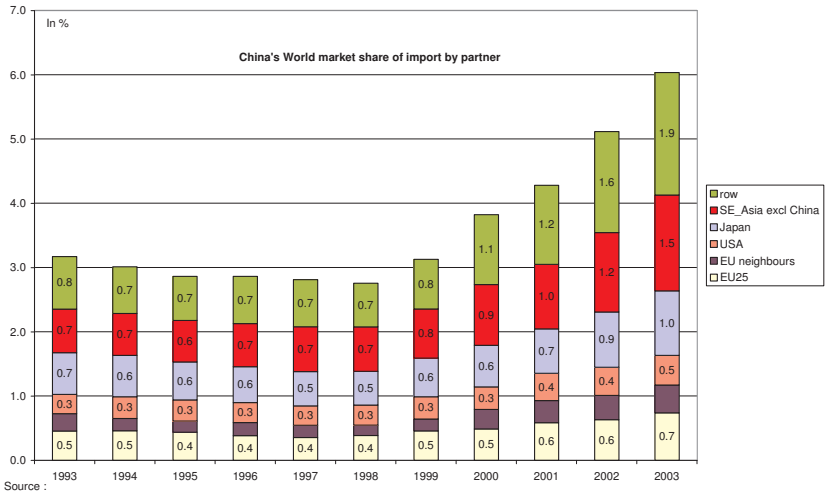
3.1.1. China's Trade by geographical area

Figure 3.2 details the geographical origin and destination of Chinese trade. Both on the import and export side, the intra-South-East Asian regional dimension of China's trade is evident. South East Asia and Japan account for the majority of Chinese imports and exports, an importance that continues over time (except for Japan). This intra-South-East Asian trade is a reflection of the deep economic integration of the region (particularly Taiwan, HK and PRC). In fact, a substantial share of trade within this region is intra-company trade of multinational firms building their value added chain regionally.

Outside the South East Asian block, the US and the EU are important trading partners for China. It is interesting to note that the EU has been outpacing the US as China's major trading partner (see Chapter 14 for more details on EU-China trade). Another point of interest is the growth of trade with the rest of the world.

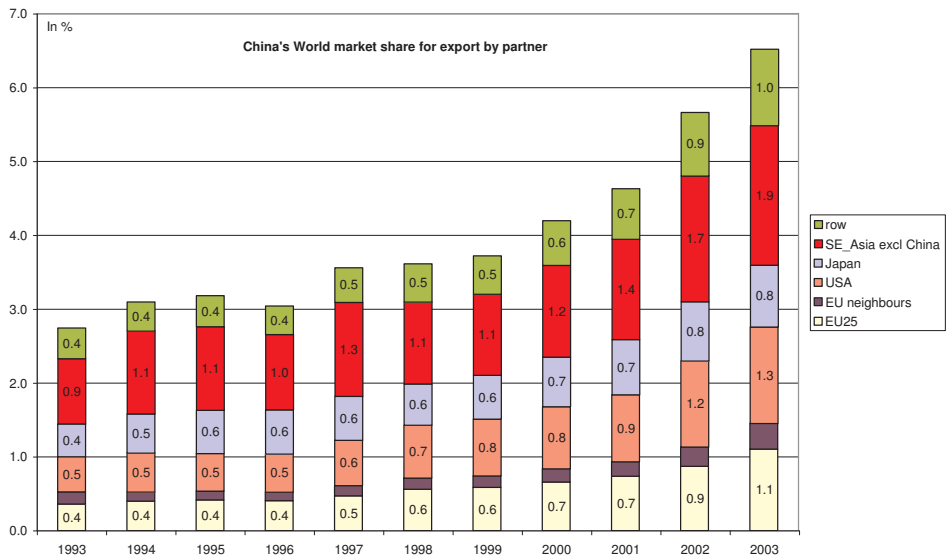
01_2006_4142_txt_EN.indd 41 12-07-2007 10:43:20

Figure 3-2: China's World Market Share of Imports by Partner



Source :

China's World Market Share for Exports by Partner



Source : EC Delegation on the basis of MOFCOM

The most recent data for 2005 show that the EU has become the first trading partner of China, ahead of the US and Japan. Not insignificant shares are accounted for by Latin America (4%) and Africa (3%). Nevertheless, the Asian region remains the most dominant for Chinese trade.

01_2006_4142_txt_EN.indd 42 12-07-2007 10:43:20

Figure 3-3: China's Top 10 Trading Partners 2005

(Share in total Chinese Trade (X+M))

Country		Region	
1. EU-25	15.3%	1. Asia	56%
2. US	14.9%	2. Europe	19%
3. Japan	13.0%	3. North America	16%
4. HK	9.4%	4. Latin America	4%
5. ASEAN	9.1%	5. Africa	3%
6. ROK	7.9%	6. Oceania	2%
7. Taiwan	6.4%		
8. Russia	2.1%		
9. Australia	1.9%		
10. Canada	1.4%		

Source: MOFCOM

Overall, China exports more than it imports, thus keeping a trade surplus. For instance, in 2005 the trade surplus amounted to 7% of total trade flows. This surplus is first and foremost with the US, but trade is also in surplus with the EU-25 and Hong Kong. China runs a trade deficit with most other Asian countries (Taiwan, Korea, Asean10), and to a lesser extent Japan. With Africa, Latin America and Oceania, there is a small trade deficit. Overall, the major issue is the big and persistent trade surplus with the US, which is very largely behiFnd the current tensions in Sino-US relations.

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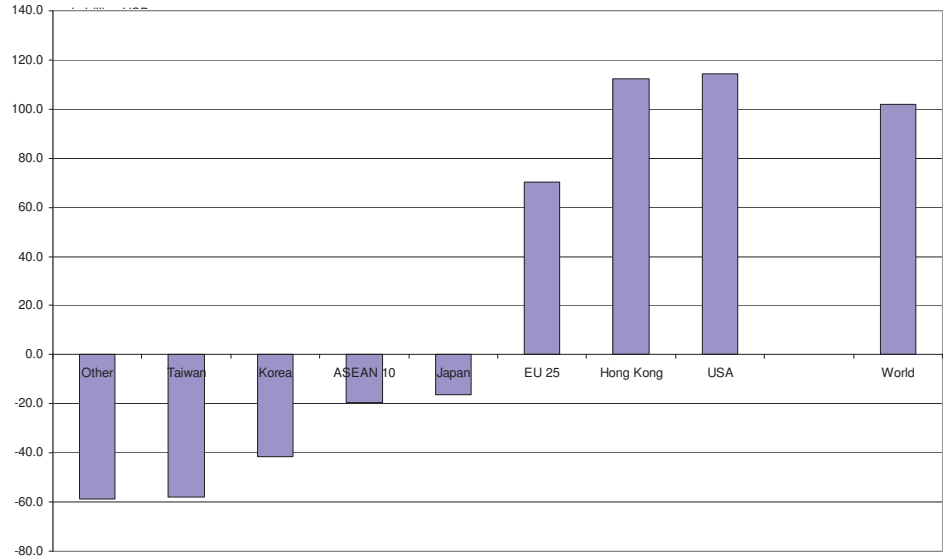
Figure 3-4: Trade Balance of China vis-à-vis trading partners (2005, bill USD)



Source: Customs General Administration of the People's Republic of China

3.1.2. China's comparative advantage in world markets

The reform process and rapid economic development have gone along with a sizeable shift in China's (Revealed) Comparative Advantages (RCA).[58] While resource-intensive, low-tech and labour-intensive products lay at the heart of China's export activities during the 1980s, the country's export structure had changed quite dramatically. The table below sets out China's RCA indices in global trade in 1995, 1998 and 2001 for those industries with positive RCA in 2001. While labour-intensive products still command positive RCA values, there are nonetheless positive and strongly increasing RCA values in some medium-tech and more capital intensive products, most notably *office machines and automatic data processing machines* (75) and *telecommunication and sound recording apparatus* (76).

[58] The Revealed Comparative Advantages (RCA) of a specific sector is measured by the ratio of the export share of this specific sector to the export share for all products. An RCA value larger than 1 indicates that the country specialises in this sector, commanding a share in world export markets that is higher than the country's average share in world export markets.

01_2006_4142_txt_EN.indd 44 12-07-2007 10:43:20

Table 3-2: China's Revealed Comparative Advantages in Global Trade, 1995, 1998, 2001

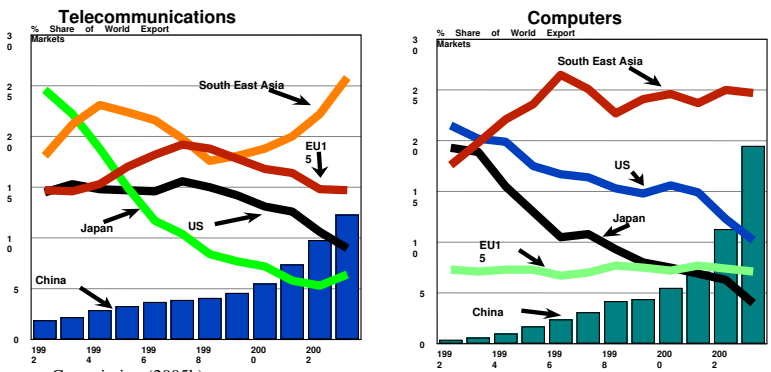
SITC-Classification / Product group		1995	1998	2001
85	Footwear	157.4	174.3	158.0
84	Articles of apparel & clothing accessories	162.4	165.0	145.8
83	Travel goods, handbags, etc.	153.1	170.3	142.0
32	Coal, coke and briquettes	75.6	73.9	113.1
81	Prefabricated buildings, sanitary, heating and lighting fixtures, n.e.s.	68.3	70.6	87.9
65	Textile yarn and related products	99.3	78.7	84.6
82	Furniture and parts thereof	39.0	45.8	62.4
52	Inorganic chemicals	85.6	78.4	58.5
76	Telecommunication and sound recording apparatus	25.9	28.2	51.5
75	Office machines and automatic data processing machines	-43.1	13.4	49.9
69	Manufactures of metal, n.e.s.	31.5	39.7	48.2
88	Photo apparatus, optical goods, watches and clocks	20.2	31.3	1.8

Sectors with positive RCA values in 2001. Ranking according to 2001 RCA-values. Calculations based on OECD data.

Source: European Commission (2005a).

Exports of high-tech products grew rapidly, increasing their share of overall exports from 11% to 25% (1998-2003). At the same time, the Chinese economy is increasingly importing high-tech products. Between 1998 and 2003, China's imports of high-tech products as a share of total imports increased from 21% to 29%. Within high-tech sectors, China has been able to secure substantial shares in telecom and computers, two of the fastest growing global export markets. Accordingly, China in 2004 overtook the US to become the world's leading exporter of ICT goods.[59]

Figure 3-5: World export market shares for Telecommunication and Computers



Source: European Commission (2005b).

At the same time, China is shifting its import demand. While China previously relied on electronic components, such as chips, imported from the US and the EU, these are now increasingly being produced in China and/or sourced from other Asian countries. As a

[59] China is the single largest exporter of ICT goods to the US, supplying 27% of US imports in 2004 (10% in 2000). OECD (2005)

01_2006_4142_txt_EN.indd 45 12-07-2007 10:43:21

consequence, China runs a trade surplus in ICT with both the US and the EU and this surplus continues to rise.[60]

Since the latter half of the 1990s China has become the hub of electronics manufacturing in the developing world and a key part of the value chain in many electronic products. There are nevertheless marked differences across submarkets. The build-up of local production facilities has been much faster in PCs and peripherals than in the field of consumer electronics. This follows a typical pattern. Initially, resource-seeking FDI has been highly welcomed in China, offering tax and other incentives, while market-seeking FDI has been largely discouraged. Technology transfer from this FDI has been nurtured. Gradually government and entrepreneurs have started to reduce the strong dependence on foreign technology and have started to develop their own system technologies (for example the mobile phone protocol TD-SCDMA and the EDS system for DVD standard), which helped to protect domestic firms from foreign competition in the Chinese market. Chinese firms in the electronics industry have considerably increased their productivity and secured a large part of total manufacturing output. In this success, government industrial policy has had a crucial impact, supporting domestic manufacturing, offering tax and other incentives, and access to cheap loans, and pressing forward Chinese standards.[61]

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60 OECD (2005)

61 Broadband Wireless is an area where the Chinese are at a disadvantage in that they have not yet reached the level of design sophistication and component functionality of their foreign counterparts such as Nokia. One area of broadband wireless that remains uncertain is the future of WiFi. In 2004 China declared its own WAPI standard to replace the WiFi for security reasons, but later withdrew its plans. But the issue has come up again in 2006 (EC (Trade) 2006)).

01_2006_4142_txt_EN.indd 46 12-07-2007 10:43:21

Box 3-1: A computer "Legend" in the making

Legend (rebranded in 2003 as Lenovo) is one of the biggest and earliest success stories of the Chinese IT industry. It is one of the three biggest PC makers in the world, after taking over IBM's PC business in 2004. In China it is the biggest seller of PCs, with more than a quarter of the Chinese market.

Legend was founded in 1984 by eleven scientists on Beijing campus. It started as a distributor of foreign brands (IBM, HP etc), building up an elaborate distribution network in China. Although the company was state-owned, it was structured from the start as a private company, with the founders managing to bring in outside capital for the initial investment (RMB 200000 or $24000). It benefited early on from central government's desire to nurture a strong indigenous IT sector. Liu Chuanzhi (founder & chairman of the Legend group, a computer engineer from the Chinese Academy of Sciences) obtained from the government certain quite independent financial decision-making power and the power to set wages and bonuses for his employees. However, when Legend wanted to make its own PCs, the government initially did not give permission for production in China. So Legend first set up a factory in Hong Kong. But after its first success, it soon obtained a licence and went back to China, where the first Legend branded PC rolled off the production line in 1990. It also serves systems integration for large government clients.

In 1994 it listed its Hong Kong arm on the Hong Kong stock exchange. It currently has a Hong Kong and New York listing. This has allowed the company to tap international investors to fund its growth, but also to improve its corporate governance and transparency from (international) shareholder pressure. In addition, it allowed the company to offer stock options to its employees, to tie their incentives closer to the firm's performance. Another big strength of the company over its mostly foreign rivals is the broader access and deeper knowledge it has of the Chinese market. While foreign (US) companies do R&D mostly with a view to global markets, Lenovo conducts R&D for the Chinese market, e.g. adapting keyboards suited for Chinese characters and voice input and developing software for Chinese enterprises.

Source: On the basis of Mc Kinsey Quarterly and other news excerpts.

3.1.3. China's role in the international division of labour[62]

To highlight the role which China plays in the international value added chain, this section will look at China's comparative advantages at the different stages of production of traded goods. The table below gives a breakdown of Chinese exports and imports by stage of production.

Table 3-3: Trade Pattern and Comparative Advantage by Stage of Production

	% Break-down of Imports*		% Break-down of Exports*		Actual trade balance (% of GDP)	
	1992	**2003**	**1992**	**2003**	**1992**	**2003**
Intermediate Goods	57.7	71.9	29.5	38.1	-5.1	-8.0
(Primary Goods)	8.1	11.8	7.6	2.6		
(Parts and Components)	11.3	28.3	3.1	15.9		
(Semi-Finished Goods)	38.7	31.9	18.3	19.6		
Final Goods	23.9	25.3	46.5	60.8		
(Consumption)	3.6	3.5	40.1	36.6	7.5	9.0
(Capital)	20.2	21.8	6.4	24.2	-2.6	1.0
Total	100.0	100.0	100.0	100.0		

* Individual components do not add up to 100 since "unclassified" goods are not included in the table.

Source: European Commission (2005b).

62 Based on European Commission (2004).

01_2006_4142_txt_EN.indd 47 12-07-2007 10:43:21

On the imports side, it shows a sharp increase in the share of intermediate goods in total imports, with this increase being mainly driven by a more than doubling in the import share of parts and components. This table clearly shows the rapidly changing structure of Chinese trade, away from a model based on imports of raw materials and exports of final goods to one based on specialisation in different stages of the production of specific product groupings.

China's comparative advantage lies in the downstream stages of production (i.e. final goods), while the upstream stages (i.e. intermediate goods) displayi large structural deficits. With China's position changing in this way from comparative advantage to disadvantage depending on the stage of production, vertical specialisation is a hallmark of the Chinese development model. Within the international division of labour, China **specialises in the processing and assembly** of a wide range of intermediate goods, most notably parts and components and semi-finished goods, but also more recently a range of basic materials. The large deficits in all areas of intermediate trade and surpluses in both categories of final goods, i.e. consumption and capital goods, suggests China is still mainly an assembly country on average, a position which is similar to a large number of other low-wage South East Asian economies. But in terms of **trend** China's future position is very likely to shift **away** from its role as a pure assembly country. The following graphs give a breakdown of how China's trade has changed since the early 1990s by main trading partners as well as by nature of goods.

Figure 3-6: China's overall trade in intermediate goods by main trading partners

(Trade Balances as a % of GDP)

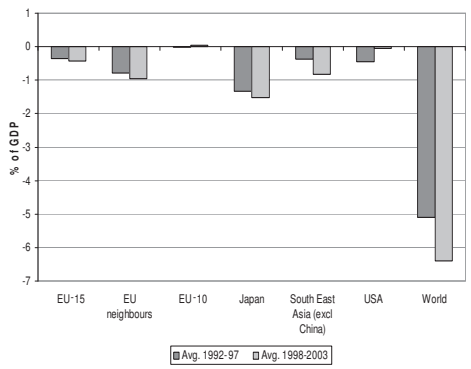
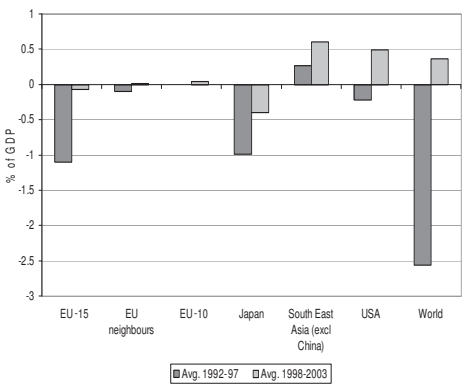


Figure 3-7: China's overall trade in capital goods by main trading partners

(Trade Balances as a % of GDP)



Source: European Commission (2005b).

The graphs make a number of points. Firstly, while China has deficits in its trade in intermediate goods with all areas of the world, in terms of parts and components and semi-finished goods there is a relatively heavy concentration of such deficits with Japan and other South East Asian countries. This pattern suggests that production sharing is characterised by a **strong regional dimension**. Secondly, the recent shift towards structural surpluses in capital goods suggests that China is beginning to **move up the value added chain.** Such a move should be of concern to the TRIAD group since they have traditionally had a comparative advantage in the production of such goods. The strong surplus in it's the EU's trade with China in such products has been wiped out over recent years. Japan's surplus has been more than halved, and the US has gone from

01_2006_4142_txt_EN.indd 48 12-07-2007 10:43:22

surplus to deficit over the course of the period as a whole. This is a feature of a range of US dominated high technology product areas, most notably in the ICT sector (cf above).

3.2. Outward-Bound FDI – One Step Further Towards Global Significance

In comparison to the huge flows of inward-bound FDI, outward-bound FDI originating in China remains of minor magnitude. Nevertheless, the rising intensity of outward investment activities by Chinese enterprises signals a new stage in China's integration into the global economy.

Outward-bound FDI still constitutes one of the most heavily regulated fields in the Chinese economic system. Until the early 1990s, when foreign exchange was a scarce and very precious resource, China's FDI in- and outflows were greatly influenced by political and macroeconomic considerations. The overall development strategy, as devised by the economic bureaucracy in Beijing, still playis an important role with respect to China's outward FDI in the raw materials sector (cf above). Large purchases of oil and gas sources have been made in Kazakhstan, Australia and Indonesia. But today, it is increasingly the commercial and the strategic business development interests of individual enterprises that drive China's outward FDI activities. Outward FDI provides a way for large Chinese companies to expand abroad and gain access to distribution channels, trademarks and technology.[63]

Starting from almost zero, China's outward FDI has recently risen to considerable levels, turning China into one of the most important developing country investors. The figures presented here are, furthermore, likely to under-represent the true volume of Chinese overseas investments, as FDI conducted by companies registered in Hong Kong and other regions but controlled by mainland China is not included.

Table 3-4: China's Outward-bound FDI Flows and FDI Stock, mio. US$

	1990	1995	2000	2002	2003
Worldwide Total (US$ bn)	1.03	1.89	3.73	9.34	11.42
%					
EU-15	2.6	2.4	1.6	1.8	6
USA	28.1	18.7	13.6	8.9	8.3
Japan	0.7	0.8	0.5	0.9	0.8
SE Asia	17.4	18.4	22.7	56.2	52.6
Africa	4.9	6.5	17.6	8.8	8.1
Latin America	5.6	4.9	14.2	7	7.2

Source: Clegg (2005)

China's outward FDI was during the early stages of development highly concentrated in Hong Kong. Hong Kong functioned as a "window to the world" for state-owned enterprises, various branch ministries as well as local governments. They regarded Hong Kong subsidiaries as vehicles for promoting the export economy of their home localities, earning foreign exchange, accessing international capital markets, and providing training possibilities for young managers (Taube, 1997).

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[63] Recent purchases include the computer manufacturer Lenovo's purchase of IBM's PC division, the TV manufacturer TCL's purchase of the French Thomson TV division, Shanghai Automotive acquiring Korean Ssangyong, and Nanjing Automobilie's acquisition of British MG Rover.

01_2006_4142_txt_EN.indd 49 12-07-2007 10:43:22

In recent years the geographical reach of outward FDI has increased substantially, as China's multinationals start to explore global markets. Between 1979 and 2002, about 60% of China's cumulative investment value was directed towards Asia, followed by North America, Africa, and Latin America.[64] Europe ranks fifth, with FDI inflows only a fraction higher than those directed towards Oceania, and Germany, in 22nd place, is the only European country listed in China's top 30 FDI destinations.

The bulk of China's outward FDI is still focused on trading activities, i.e. motivated by the desire to promote China's export industry. In addition to such market oriented activities, Chinese enterprises are also making resource oriented investments in the industrialised as well as in the developing world. The investments in the developed countries are motivated by a desire to gain access to new technologies and know-how. More recently, Chinese multinationals are beginning to invest with a view to establishing their own brands in the Western markets, acquiring distribution networks as needed.[65]

Securing natural resources for the further development of the Chinese economy lies at the heart of a rising share of FDI directed at oil and natural gas, exploration and exploitation projects, mining ventures, as well as other natural resource-based projects predominantly in Central and South East Asia, but also in Africa and Latin America.[66]

3.3. The impact of growing energy and raw materials demand in China [67]

While China's entry into world markets has provided global customers with cheaper products, thus contributing to restricted levels of inflation in the West, China's growth has instigated concerns about the possible effect on energy and raw material supply and prices. Chinese demand remains relatively low for its size (in terms of per capita consumption levels), but is growing rapidly. Over the past decade, China has managed to keep its energy growth rate well below its rate of GDP growth. However, a shift to levels of consumption closer to the developed world could increase the impact of China on global raw materials markets, depending on how Chinese demand evolves. IFRI[68] has forecasted that Chinese energy consumption will overtake Western Europe's by 2010 and North America's by 2020, with 20% of the increase in consumption coming from foreign suppliers.

Fossil fuels are the major component of China's **energy** demand. Coal still provides about two thirds of China's energy, while oil accounts for one quarter. Beijing would like to shift China's current energy mix more towards natural gas, renewable energy and nuclear power. Beijing also intends to continue to improve energy efficiency and promote the use of clean coal technology.

The table below gives an overview of developments in key energy sectors in the years since 1997. In *coal* and *gas*, despite its high growth rates, China still only represents a small fraction of world imports, as its growth is starting from such a low base. It will be

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64 Data compiled by the Ministry of Commerce (MOFCOM), covering officially approved FDI only.

65 e.g. consumer goods maker Haier has succeeded in selling its own-brand fridges in Wal-Mart stores, rather than rebranded ones.

66 MOFCOM, UNCTAD, 2003a

67 Based on a contribution by DG TRADE.

68 IFRI

01_2006_4142_txt_EN.indd 50 12-07-2007 10:43:22

some time before it becomes a really significant player, even if growth continues at present rates.

But *oil* consumption has been growing particularly strongly, with imports covering almost all of this growth.[69] Petroleum imports have been rising by an annual 13% over the period 1997-2002. In 2004, China's crude oil imports originated 45% from the Middle East (of which 11% from Iran), 29% from Africa (of which Angola (13%), Sudan (5%)), 9% Russia and 11% Asia Pacific. Net imports of oil are expected to rise further.

Table 3-5: China's Trade in Energy

Commodity	Chinese imports 2002 bn $	Av rate of growth in % (1997-2002)	Share of world trade in % (1997)	Share of world trade in% (2002)
Petroleum	17.4	13.2	2.8	4.2
Gas	1.6	12.7	1.5	2.1
Coal	0.3	28.7	0.4	1.5

Source: DG Trade.

In **raw materials**, demand is not equally important in all sectors and although growth rates are high, demand often started from such a low base that China is still not a significant importer. Over the period 1997-2002 China rapidly increased its iron and steel consumption and is now the world's largest steel consumer and a net importer. As illustrated by the table below, China's market share has increased in all sectors under consideration – sometimes very significantly, like in iron ore and copper.

Table 3-6: China's Trade in raw materials

Commodity	Chinese imports 2002 bn $	Av rate of growth in % (1997-2002)	Share of world trade in % (1997)	Share of world trade in% (2002)
Iron Ore	2.8	11.4	12.7	22.9
Iron and steel	13.7	15.2	6.6	15.3
Base metal ores	2.3	16.2	5.4	12.3
Copper	4.4	21	7.2	22.4
Aluminium	2.1	12.2	3.5	6.2

Source: DG Trade.

High growth rates and rising importance in global terms inevitably mean that developments on the Chinese market are having an ever stronger influence on world prices of raw materials and energy. The suddenness of the change in certain sectors may also imply that a smooth supply response cannot necessarily be assured. Nevertheless, at this stage, it is impossible to make predictions about the impact of Chinese import growth on prices. Much depends on the specific circumstances of the sector and the elasticity of supply within it.

3.4. Conclusion

China has become an important player in the world economy. Total exports and import volumes were exceeded only by the US and Germany. Most of China's trade patterns still reflect a specialisation in processing and assembling intermediate goods. This processing trade is mostly a foreign firm activity, particularly from Japanese and other

[69] DG RELEX, EU mission in China (2005)

01_2006_4142_txt_EN.indd 51 12-07-2007 10:43:22

South East Asian countries. Nevertheless, more recent trends suggest a move up the value added chain, particularly in the ICT sector, where China has overtaken the US as the largest exporter. Outward FDI is also rising slowly, albeit from very low levels. Although the bulk of this outward FDI is still focused on trade activities and accessing (natural) resources, Chinese firms are slowly beginning to invest abroad with a view to accessing foreign markets. In line with China's growth, its imports of energy and raw materials have been growing and are predicted to continue to grow, with a likely impact on energy prices.

China's increasing weight in world trade yields a significant potential influence. The next chapter will review how China's foreign policy has evolved in order to handle that influence, paying particular attention to relations with its Asian neighbours and its policy as regards securing its energy needs.

01_2006_4142_txt_EN.indd 52 12-07-2007 10:43:23

4. CHINA'S EVOLVING FOREIGN POLICY

Over the last decade China's foreign policy has become far more active. Its proclaimed interest is to "pursue an independent foreign policy of peace" in order to preserve "China's independence, sovereignty and territorial integrity" and "to create a favourable international environment for China's reform and modernisation."[70]

China still faces enormous internal challenges and clearly needs a benign international environment if it is to pursue its development and ensure a stable domestic environment. China has engaged the international community, including Western democracies, to foster its development, establish economic and cultural exchanges, and get access to the most advanced technologies. In its attitude toward the international community China is cautiously avoiding any confrontational approach.

China, a permanent member of the United Nations Security Council, has significantly increased its participation in international organisations, especially – but not only – financial ones. In particular, China has signed all international treaties related to non-proliferation and joined most of the relevant international organisations, including in 1984 the International Atomic Energy Agency (IAEA). China officially stands for "the complete prohibition and thorough destruction of all kinds of weapons of mass destruction (WMD), including nuclear, biological and chemical weapons." China acceded to the Treaty on the Non-Proliferation of Nuclear Weapons (NPT) in 1992, and signed the Comprehensive-Nuclear-Test-Ban Treaty (CTBT) in 1996. However, China "believes that given the dual-use nature of various materials, equipment and technologies in the nuclear, biological, chemical and aerospace fields, it is important that all countries, in the course of implementing their non-proliferation policies, strike a proper balance between non-proliferation and international cooperation for peaceful use of the relevant technologies." [71]

China is keen as well on maintaining "harmonious relations with other countries in the world" including forming a "stable and healthy relationship with the United States, instead of challenging or confronting the latter or replacing its role as a dominant power."[72] China has also worked on enhancing its ties with Europe. In 1996 China became a founding member of the Asia-Europe Meeting (ASEM), and in 2003 issued its first-ever "China's EU Policy Paper", acknowledging that "the EU is a major force in the world" and that "the Chinese Government appreciates the importance the EU and its members attach to developing relations with China."[73]

However, China stands firm on foreign demands and does not compromise on issues it regards as national vital interests. On the basis of the Five Principles of Peaceful Coexistence – mutual respect for sovereignty and territorial integrity, mutual non-aggression, non-interference in each other's internal affairs, equality and mutual benefit,

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70 China's Minister of Foreign Affairs Website - http://www.fmprc.gov.cn/eng/wjdt/

71 SIPRI: China: Basic stand on non-proliferation, http://www.sipri.org/contents/expcon/chinonprolif.html/view?searchterm=china

72 Yang Yi, Director of the Institute for Strategic Studies, National Defence University of China, quoted in "*China Adheres to Harmonious International Relations*", Xinhua News Agency January 6, 2006

73 EU- China relation will be dealt with in Part III.

01_2006_4142_txt_EN.indd 53 12-07-2007 10:43:23

and peaceful coexistence[74] – China makes sure it is in a position to defend its national interests without allowing unwelcome foreign intervention. In particular, China stands firm on dissuading Taiwan from independence. Being acutely aware that struggles for strategic resources and strategic dominance may well occur, it knows it needs to stand ready to face them, including militarily.

Since the end of the Cold War China has pushed for a multipolar world in which the United States could be counterbalanced by flexible coalitions involving at different times Russia, Europe, India, Japan and the countries of the Association of Southeast Asian Nations (***Asean***).

Over recent years, China's most significant foreign policy development and success has undoubtedly been its proactive regional posture in diplomatic, economic and security areas. China is deeply involved both bilaterally and multilaterally in the Asia-Pacific region, in particular in South-east Asia, and is building a position as a major regional power in a part of the world which is also of great economic and security significance for the United States. China's regional diplomacy serves its fundamental national interest (China regards the region as vital for its own growth and prosperity) and reflects its long-term security concerns, especially vis-à-vis the United States.

Besides, China's economic growth and development has exposed the country to two main factors of vulnerability: an increased vulnerability to maritime threats with the growing concentration of China's key economic assets along its eastern and southern coastline,[75] and an overall increased level of dependence on external markets, especially for foreign energy resources. China is eager to diversify its sources of oil supply and to "go global". It has already extended its reach into Africa, the Middle East and Latin America One specific aspect of China's quest for energy, which is shaping its foreign policy, could be of great concern for the international community and notably Europe. China is not loath to deal with autocratic regimes and is notably keen on assisting the development of some countries with no strings attached. This may well undermine efforts by the international community to make government and business more accountable and to address some of today's global threats, e.g. weapons of mass destruction, organised crime or failed states.[76]

4.1. World views of China

China is generally viewed as playing a significantly more positive role in the world than the United States. However, China's ratings in world opinion have slipped somewhat lately, notably in European countries. While there is relative comfort with China's growing economic power, this is not the case with its growing military power.

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[74] The Five Principles of Peaceful Coexistence were first set forth by Premier Zhou Enlai at the start of the 1953-1954 negotiations between China and India on relations between the two countries over Tibet. They have been widely accepted since then as norms for relations between countries and have been enshrined in China's Constitution.

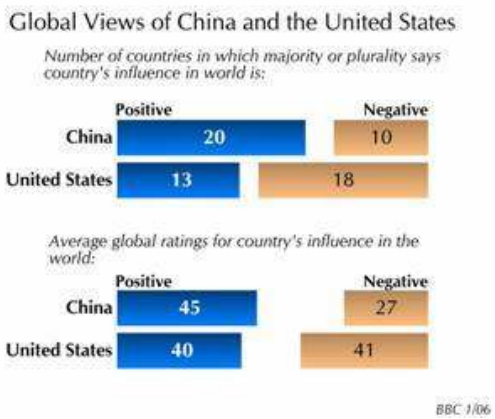
[75] China's sense of vulnerability regarding its communication sea lanes has been encapsulated in what Hu Jintao has described as the "Malacca dilemma", i.e. 80% of China's imports come through the tiny strait, and any naval blockade can wreck the Chinese economy.

[76] The European Security Strategy identifies five key threats: regional conflicts, failed states, terrorism, weapons of mass destruction and organised crime.

01_2006_4142_txt_EN.indd 54 12-07-2007 10:43:23

A poll of 33 nations (including six EU Member States: France, Germany, Italy, Poland, Spain and the United Kingdom) completed in January 2006 by *GlobeScan* and the Program on International Policy Attitudes (PIPA) for the BBC World Service asked respondents to evaluate whether certain countries were having a positive or negative influence in the world.[77] China's influence was rated positively by 20 out of 33 countries, while ten gave it a negative rating. On average 45% gave China a positive rating and 27% a negative one. Worldwide, young people (18-29 years old) and those with medium or high levels of education are more inclined to view China positively (with 58%, 51% and 52% of positive views respectively).

Looking at 20 countries polled at the beginning of 2005 and then again in 2006, in 12 of them ratings of China went down, while in two of them ratings improved. On average, its positive rating dropped by nine points. Negative shifts have occurred in four out of the six EU Member States polled. Positive ratings dropped between 2005 and 2006 in France, Italy, Great Britain and Germany. In Finland, polled for the first time in 2006, a majority of 54% view China negatively. Today only one country – Spain – still has mainly a positive view (45%).



Source: GlobeScan and PIPA for the BBC, January 2006

Negative shifts also occurred in Canada, Russia and in Asia, most notably in South Korea. In 2005 South Koreans had been divided on China (49% positive, 47% negative), while currently a 58% majority views China negatively. Positive ratings have dropped as well in India, the Philippines, Australia and Indonesia. However, in all of these cases a majority are still positive.

A December 2004 *GlobeScan* poll of 22 countries found that attitudes toward China's **growing economic power** were on the whole rather positive, with an average of 49% viewing it as a positive trend and 33% as a negative one.[78] Among the EU countries polled, the fact that China is becoming more powerful economically was viewed mainly positively in France (59% positive and 31% negative);[79] in the United Kingdom (53% positive and 34% negative); and to a much lesser extent in Poland (39% positive and 32% negative). Germany was divided between a 42% mainly positive view and a 44%

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77 http://www.worldpublicopinion.org/pipa/articles/home_page/190.php?nid=&id=&pnt=190&lb=hmpg1

78 http://www.pipa.org/OnlineReports/China/China_Mar05_rpt.pdf

79 However, a 2005 "16-Nation Pew Global Attitudes Survey" shows that when asked more specifically if China's economic growth is good for **our** country, only 37% of the respondents in France answer positively (against 56% in the UK and 53% in Germany) – http://pewglobal.org/reports/display.php?PageID=805

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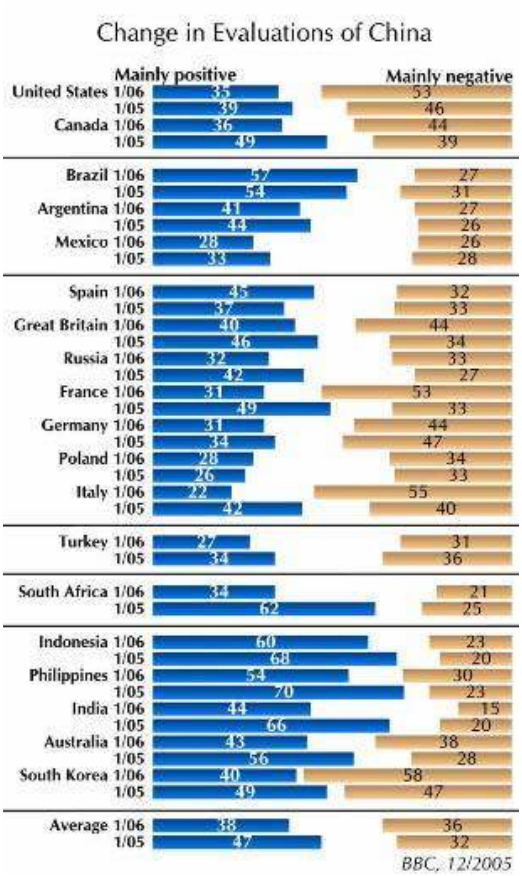

Source: GlobeScan and PIPA for the BBC, December 2005

mainly negative one, while a negative view prevailed in Italy (47% negative and 41% positive) and Spain (47% negative and 31% positive).

The prospect of China's rising economic might was viewed positively in most Asian countries including India (68%), Philippines (63%), and South Korea (54%). Only Japan was less definite (35% positive, 23% negative and 34% not taking a position). In the United States views were evenly divided (46% positive and 45% negative). Interestingly enough, a positive view was also found in countries such as Mexico (54% and only 18% negative), whose manufacturing sectors face significant competition with China.

Attitudes toward China becoming more powerful **militarily** – with an average of 59% viewing it as a negative development and only 24% as a positive one – do not correlate with the views on China becoming more powerful economically. Most citizens in the EU countries polled had a negative view on China increasing its military power (Germany 87% "negative", Spain 76%, Italy 74%, Great Britain 65%, Poland 65% and France 64%). Worldwide, the countries most concerned about the potential growth of China's military power are Germany (87%), Australia (78%), Japan (78%), Spain (76%), the United States (75%) and Italy (74%). The one country where a majority views China's increased military power positively is India (56% positive, 27% negative).

A 2005 "16-Nations Pew Global Attitudes Survey"[80] found that there is substantial support in most countries for "a military rival to challenge America's global dominance". However, the idea of China emerging as a potential military rival to the United States drew a mixed reaction, in particular in Europe, with opposition ranging from 71% in the UK, France and Russia to 82% in Germany.

4.2. China's reassurance policy

China is very much aware of the concerns raised by its rapid development.[81] It is obviously keen on reassuring the international community about its intentions and

[80] Ibid.

[81] The Vice-President of China Institute of International Relations, Ruan Zongze, notes that China's rise occurs in a very specific environment with no precedent in the history of other previous rising powers, i.e. an environment characterised by the constraints both of globalisation and the international legal framework that emerged after World War II. Ruan Zongze, *What Are the Implications of China's Peaceful Rise to the World*. http://www.crf.cn/peacefulrise/ruanzongze2.htm

01_2006_4142_txt_EN.indd 56 12-07-2007 10:43:24

convincing it that its rise is a long-haul peaceful process based on a cooperative approach which is respectful of the current international system and not out to challenge it.

In November 2003 the foreign policy strategist Zheng Bijian (who was Vice-President of the Central Party School when Hu was the School's President) coined the expression "peaceful rise", which was promptly seized upon in December 2003 both by President Hu addressing an audience that included a number of Politburo Standing Committee officials, and by Premier Wen in a speech at Harvard University. However, even though the expression is still sometimes used in Western countries, it has outlived its shelf-life in China. Many scholars opposed the very term "rise", arguing that China was not going to rise so fast. It was far too optimistic and risked masking the numerous economic and social problems facing China and complicating its arduous transition toward a market economy. "Peaceful rise" has now been supplanted in the official foreign terminology by to the return of "peaceful development".

On 22 December 2005 the State Council published a White Paper on "China's peaceful development road".[82] This document takes stock both of international concerns regarding China's rise and the internal tensions deriving from it. The main message of this White Paper is that "despite gigantic achievements, China still remains the largest developing countries in the world, with a formidable task of development lying ahead" and for its own sake to achieve such a task the country needs an internationally and internally stable and peaceful environment.

The document reaffirms the fundamental basis of China's cooperation with the outside world, the United Nations Charter and, importantly, the Five Principles of Peaceful Coexistence. These two pillars of China's views of international relations imply, as the document recalls, that from a Chinese perspective "the internal affairs of a country should be decided by its people, international affairs should be discussed and solved by all countries on an equal footing, and developing countries ought to enjoy the equal rights to participate in and make decisions on international affairs."

A week before the release of this White Paper, Zheng Bijian, now Chairman of the China Reform Forum, explained that China's peaceful development road meant that "we strive for a peaceful environment to develop ourselves while using our development to promote and preserve world peace". On its road China "has no intention" stressed Zheng "to challenge or subvert the existing international political and economic order." The objective, he said, is to seek "peace outside China", "harmony inside the country" and "peaceful settlement across the Taiwan Straits", in other words what has already been labelled by some scholars as Hu Jintao's theory of the three harmonies, *he-ping*, *he-jie* and *he-xie*.[83]

Any move by China to put an end to its peace and development line would signal a fundamental policy shift. This could be of serious concern for the rest of the world. So far the peace and development line has been seriously challenged only once under the

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constraints both of globalisation and the international legal framework that emerged after World War II. Ruan Zongze, *What Are the Implications of China's Peaceful Rise to the World*. http://www.crf.cn/peacefulrise/ruanzongze2.htm

82 People's Daily On-Line, December 22, 2005

83 Chairman Zheng Bijian, China Reform Forum, *Ten Views on China's Development road of Peaceful Rise and Sino-European Relations*, The Foreign Policy Centre, London, December 15, 2005

01_2006_4142_txt_EN.indd 57 12-07-2007 10:43:24

1999 accidental bombing of the Chinese embassy in Belgrade during the NATO operation.

4.3. The regional opening-up of China's foreign policy

In the 1990s China launched its great regional diplomacy drive (*da zhou bian wai jiao*) for amicable, secure and prosperous neighbourhood relations. The intention was in the short term to secure China's position at a time of international isolation subsequent to the Tiananmen Square protests crackdown, and in the long term to consolidate China's place in the Asia-Pacific region, especially in South-east Asia.

Under the great regional diplomacy initiative, China worked on deepening ties with some 18 countries in the region.[84] China's opening up to the international community was also marked by the end of its sceptical stance towards regional and multilateral institutions which were previously perceived as a constraint on China.[85] The current dominant trend is to view those organisations as venues for China to pursue its economic interests, expand its regional influence, address mutual security threats, and check the United States regional interests.

Indeed China has founded, joined and upgraded its participation in a number of regional fora, notably those in which the United States is not the hub. China has deepened it participation in the Asia-Pacific Economic Cooperation (***APEC***) forum and hosted for the first time ever an APEC Leaders' meeting in Shanghai in 2001.

4.3.1. Central Asia

"Central Asia is the backyard of Russia, but China is making extremely aggressive inroads" says Niklas Swanström of Sweden's Uppsala University.[86] Actually Russia has long historical political and cultural ties with this region rich in oil and gas, and where China has a growing economic interest in maintaining a stable environment. The Shanghai Cooperation Organisation (SCO) became a way of fostering China's strategic economic and security objectives in Central Asia while reassuring Russia, the other prominent SCO member.

China led the efforts to establish in 2001 the SCO, which begun as the Shanghai Five in 1996 (China, Russia, Kazakhstan, Kyrgyzstan and Tajikistan. Uzbekistan was invited to

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[84] Notably China's diplomatic relations were normalised with Laos and Vietnam, then Malaysia and Cambodia, and diplomatic ties were established with Singapore, South Korea then Brunei. Moreover China addressed and settled a number of territorial disputes with Laos, Russia, Vietnam, Kazakhstan, Kyrgyzstan and Tajikistan; in each and every settlement China received 50% or less of the contested territories. Some disputes remain unsettled, such as the one between China and India that led to the 1962 war, but tensions over this issue have significantly decreased. China and India have passed two agreements that led to important troop reductions and confidence building measures. Many observers consider that the "Line of Actual Control" in the Himalayas is increasingly viewed as a mutually acceptable border.

[85] China has always been cautious to stress that its regional policy in particular and its view of international relations in general are based on partnerships and not alliances. That is one way to differentiate between China's foreign policy approach and the American alliance-type relationship.

[86] Niklas Swanström, director of the Contemporary Silk Road Studies Programme at Sweden's Uppsala University, quoted by Benjamin Kang Lim and Chris Buckley, China, Russia, Central Asians plan anti-terror drill – Washington Post, April 26, 2006

http://www.washingtonpost.com/wp-dyn/content/article/2006/04/26/AR2006042600271.html

01_2006_4142_txt_EN.indd 58 12-07-2007 10:43:24

join in 2001). The organisation's role gradually moved from resolving border disputes to fighting the "three evils" of extremism, terrorism and separatism, and promoting greater regional economic integration and development. Security is obviously a fundamental concern. All SCO Member States face serious challenges from militant Islamist groups. That may be a reason why "unlike the West, China and Russia sympathise with the problems that the region's often harshly authoritarian states face with militants."[87] The SCO members have created a Regional Antiterrorist Structure (RATS) and signed the "Shanghai Convention on Terrorism, Extremism and Separatism".

The SCO Member States cover an area that represents about three fifths of Eurasia, with a population about a quarter of the world's total. In 2004 Mongolia became the first country to receive observer status; then Pakistan, India and Iran received observer status at the 2005 SCO summit in Kazakhstan. Should those countries ever become full members the SCO will then represent 40% of the world's total population.

Furthermore the region's important reserves of oil, gas and minerals, and its strategic position are also of great interest for Europe, the United States and Japan. India is interested as well in gaining access to Central Asia's gas supplies and has stepped up its activities in the region. Central Asia could therefore become the ground for sharper rivalries between those different players.

[87] Niklas Swanström, *Op.cit*.

01_2006_4142_txt_EN.indd 59 12-07-2007 10:43:24

Box 4-1: China Russia relations

China and Russia share a 4 300 km-long border and for many years have entertained mutual suspicion and enmity. It seems that pragmatism is now prevailing in their relationship. Over recent years China and Russia have settled their long-standing border disputes, which brought the two countries to the brink of war in 1969, and have enhanced their co-operation in different areas of common interest.

In 2005 President Vladimir Putin and President Hu Jintao met four times within a year. In March 2006 on the occasion of the official inauguration of China's year of Russia, the two countries issued a joint statement pledging to tighten their ties by furthering co-operation in politics, energy and regional affairs. 2007 will be Russia's year of China.

• Energy co-operation

With 13% of the world's oil and 45% of its gas, Russia ranks among the top world producers and is an essential energy partner for China. Unsurprisingly energy co-operation is high on the two countries' agenda of issues of common concern. Russia currently meets 8% of China's energy needs and the two countries are engaged in discussions to expand their energy co-operation on a number of fronts. Should China succeed in fostering its energy links with Russia it would decrease its vulnerability to maritime threats for the transport of raw energy. However, in the past few years Russia has actively played its "oil card" between China and Japan. Furthermore during Putin's visit to Beijing in March 2006 a series of energy agreements was signed, covering notably the delivery of natural gas and crude oil, but fell short of China's expectations.[88] Notably, Russia made it clear that until a feasibility study had been completed there would be no progress about a separate Siberian pipeline to deliver oil to North-eastern China, which is viewed by China as vital to satisfying to its growing energy demands. Besides Russia does not want to be only a raw energy supplier to China. In particular, Russia is keen on ensuring further Chinese contracts for Russian reactors. Two Russian reactors are currently being built in China and one should be operational by the end of 2006. This project is worth $3.2 billion. President Putin emphasised during a press conference that "co-operation in the energy sector is not limited to deliveries of raw energy [it] includes deliveries of Russian energy equipment. This refers to nuclear energy and the fact that Russia will continue to participate in establishing new nuclear energy capacities for China."

• Economic co-operation

Sino-Russian economic relations developed slowly in the 1990s. By 2005. the bilateral trade volume had reached nearly $30 billion, i.e. a 37% increase over 2004, and the two countries have pledged to double that level at least by 2010. China is likely to become the second largest trading partner to Russia.

• Military co-operation

Since the end of the Cold War China and Russia have renewed and further developed their bilateral military trade relationship. Today China is by far the largest market for Russian arms. In fact, the PLA is mainly based on Russian equipment and technologies. China notably relies on Russia for fighter aircraft, submarines and air defence system. Russia has also transferred missile and nuclear technology to China. In August 2005 the first-ever China-Russia bilateral military exercise, *Peace mission 2005*, conducted along China's north-eastern coastline and involving 9 000 Russian and Chinese troops, was an opportunity for Russia to sell more military hardware to China. It also signalled to the United States that they were not the only security guarantor in the region.

• Some convergent world views and interests

Some analysts consider that the 1999 Kosovo crisis acted as a catalyst for stronger Sino-Russian relations and strengthened their shared concern for the emergence of a multipolar international order.

In July 2005 President Hu Jintao and President Putin signed a Joint Declaration on the International Order in the 21st Century, calling for adherence by countries in the world to international law and to some key principles, including mutual respect for each other's sovereignty, mutual benefit and non-interference in each other's internal affairs, a major role for the UN, multilateralism, equal dialogue, development, and a new security framework for the world.

On the specific issue of Iran, both China and Russia have strong commercial and strategic interests in Iran, which has a SCO observer status, and both would like as well to preserve the existing non-proliferation regime.

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[88] See Yu Bin, *China's Year of Russia and the Gathering Nuclear Storm*, A Quarterly E-Journal on East-Asian Bilateral Relations. Volume 8, Number 1, First Quarter 2006 – Centre for Strategic and International Studies (CSIS)
http://www.csis.org/images/stories/pacfor/0601qchina_rus.pdf

01_2006_4142_txt_EN.indd 60 12-07-2007 10:43:25

4.3.2. South-east Asia

Since the 1997 Asian financial crisis and China's decision to come to the rescue of the affected countries by revaluing its currency to help stabilise the regional economic order, the Association of South-east Asian Nations (Asean) has enhanced its relations with China, Japan and South Korea (Asean + 3). China has increasingly become a pro-active player with an ever higher profile in this regional forum. In 2003 China formally acceded to Asean's Treaty of Amity and Cooperation in South-east Asia (TAC), becoming the first non-Asean nation to do so.[89]

The emerging role of China in the region reflects its growing economic importance to the region. Over this last decade China has been a significant trading partner and has conducted a skilful diplomatic operation. China has increasingly invested in South-east Asia and has augmented its aid and development assistance. China's trade and investments are fast becoming the engine of economic growth in South-east Asia (*see economic section*) but not only that – Chinese culture too is spreading throughout the region. China considers higher education as a paramount element of statecraft and is keen on training future generations of intellectuals, technicians and political elites of the region in its universities and colleges.

Asian countries for their part tend to view China's rise as inevitable and obviously prefer to see China engaged in as many ways as possible. A number of China's neighbours remain concerned about China's real intentions and in particular about the development of China's power projection capabilities and the potential for the use of force against Taiwan.

Some analysts suspect that China plans to become the predominant force in South-east Asia by putting in place a grid of relationships that places Beijing in a position of leadership and influence while isolating the United States from its traditional security role and its allies in the region.[90] However, China is far from being the only major player in the region and must share the regional stage with the United States, Japan and, increasingly, India.

4.3.3. The limits of China's influence over Asia

4.3.3.1. A diverse region

Asia is a region marked by disparate geography, languages, political systems – from democracies to authoritarian regimes – standards of living, and degrees of integration with the outside world. Those factors are probably major obstacles to deep integration, and they also play a role in the diverse regional perceptions of China's economic rise. Asean countries benefit differently from trade with China according to their respective

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89 The Treaty of Amity and Cooperation dates back to 1976 and stipulates that relations between the signatory countries should be based on the following fundamental principles: mutual respect for independence, sovereignty, equality, territorial integrity, and national identity of all nations; the right of every State to lead its national existence free from external interference, subversion or coercion; non-interference in the internal affairs of one another; settlement of differences or disputes by peaceful means; renunciation of the threat or use of force; and effective cooperation among themselves.

90 For example, according to Francis Fukuyama, "the Chinese know what they are doing: over the long run, they want to organize East Asia in a way that puts them in the centre of regional politics. They can succeed where ¨then Malaysian Prime Minister] Mahatir failed because they are an economic powerhouse capable of doling out favours." Wall Street Journal, March 1, 2005

01_2006_4142_txt_EN.indd 61 12-07-2007 10:43:25

level of development. The less developed Asean countries will need some time to make the necessary adjustments not to be overwhelmed by the Chinese, especially in the labour-intensive industries. In some sectors, such as electronics, motorcycles, fruits and vegetables, in which Chinese goods have begun to supplant those produced in South-east Asia, China's expansion is not welcome, and since January 2005, the surge in China's textile export has also generated stiff competition for countries such as Cambodia and Vietnam.

4.3.3.2. An unstable region

North-east Asia is the theatre for two latent conflicts, the Taiwan Strait and the Korean Peninsula. Taiwan remains a major security risk in the region, and a crucial factor in Sino-U.S. relations. The anti-secession law passed by China in 2005 raised concern around the world. Much attention has been paid to the bellicose language of Article 8, that authorises the use of non-peaceful means should possibilities for a peaceful reunification with Taiwan be completely exhausted. The European Union immediately issued a statement expressing concern and urging "all parties to avoid any unilateral action which might rekindle tensions." However, the Chinese side stressed that other articles of the law should not be ignored, such as Articles 6 and 7, which lay out a series of measures to maintain peace and stability in the Taiwan Strait and promote cross-strait relations. They affirm that China "stands for the achievement of peaceful reunification through consultations and negotiations on an equal footing between the two sides of the Taiwan Strait." Indeed the Chinese leadership continues to signal its interest in expanding cross-strait economic, tourism and cultural ties, a move backed by the Taiwanese business community, including within the ruling Democratic Progressive Party (DPP). 2005 began with the cross-strait flights on the occasion of the Chinese New Year, the first such flights in 56 years. When the two sides agreed on these flights, China had already announced its anti-secession law, which was subsequently adopted on 14 March 2005. The second round of direct New Year's flights was conducted successfully by both sides between 20 January and 15 February 2006 with an increased number of flights and of cities served. Furthermore China is out to improve its contacts with Taiwan's main opposition parties (the Nationalist Kuomintang – KMT – and its junior partner the People First Party –PFP) while deliberately avoiding contacts with representatives of the Taiwanese government or the ruling DPP. This clearly means that the Chinese leadership has no intention of doing business with the Taiwanese President Chen Shui-bian during his remaining two years in office.

01_2006_4142_txt_EN.indd 62 12-07-2007 10:43:25

Box 4-2: The Taiwan issue: Three different views on the status of Taiwan

⇨ **The United States** has basically developed a policy approach of "strategic ambiguity" over the Taiwan issue. The U.S. legal position from the 1950s on is that the status of Taiwan is undetermined. However, the U.S. does not support formal independence. In 1979, the U.S. changed its diplomatic recognition from Taipei to Beijing, recognising the Government of the PRC as the sole legal government of China and acknowledging the Chinese position that there is but one China and Taiwan is part of China. As part of de-recognition, the U.S. also notified the Taiwan authorities that as from 1 January 1980, it would terminate the 1954 Mutual Defence Treaty. Subsequently, the U.S. affirmed its security and other interests in Taiwan through the Taiwan Relations Act (TRA - 1979) and the continued supply of U.S. military equipment of a defensive character to Taiwan. The TRA states in particular that the U.S. policy is "to make clear that the United States decision to establish diplomatic relations with the People's Republic of China rests upon the expectation that the future of Taiwan will be determined by peaceful means"; and "to consider any effort to determine the future of Taiwan by other than peaceful means, including by boycotts or embargoes, a threat to the peace and security of the Western Pacific area and of grave concern to the United States."

⇨ **The PRC** position is that Taiwan was handed to China after World War II. The PRC bases its claim on the 1943 Cairo declaration of the Three Powers – Great Britain, the United States and China – which affirms that "Japan shall be stripped of all the islands in the Pacific which she has seized or occupied since the beginning of the first World War in 1914, and that all the territories Japan has stolen from the Chinese, such as Manchuria, Formosa, and the Pescadores, shall be restored to the Republic of China." China's explicit political aim remains re-unification even if it is not in a hurry to achieve it. It seems that the Chinese leadership is currently relying more on China's "soft power" to achieve this goal while trying to isolate Taiwan diplomatically (e.g. to prevent Taiwan from being part of or involved in international organisations) and maintaining military deterrence.

⇨ **Proponents of Taiwan Independence** argue that the status of Taiwan is determined, Taiwan being an independent, sovereign state. They claim that the Cairo declaration is a non-binding document as it remains unsigned (it was released on 27 November 1943, albeit unsigned). Furthermore they stress that the Treaty of San Francisco (1952), which formally declared the end of the war between Japan and each of the Allied Powers, states that Japan renounces its ownership over a number of areas including Taiwan but does not specifically state which nations are sovereign over these areas.

As for the Korean Peninsula, since the 1990s Beijing has engaged in a delicate balancing act, "courting ties with Seoul while remaining mindful of Pyongyang's interests and survival. (..)". These deft manoeuvres have raised China's strategic profile over the Peninsula, making Beijing an indispensable arbiter in any negotiations related to unification to its own liking."[91]

The **South China Sea** is of crucial importance for regional and international trade. It is a zone rich in fisheries and above all expected to have oil and gas reserves. Moreover, China views the South China Sea as an exclusively Chinese sea and claims nearly its entire territory. The Parcel islands are also claimed by Taiwan and Vietnam, and the Spratley islands are partially claimed by Brunei, Indonesia and the Philippines, and are also fully claimed by Vietnam and Taiwan In this context, the build-up of China's southern fleet worries the other claimants, who are unable to organise themselves and to reach some common position. The South China Sea is nothing but a source of disunity. Asean has tried to address this problem. In 1992, the Asean Declaration on the South China Sea was an attempt to promulgate a code of conduct based on self-restraint and peaceful dispute resolution, but did not deal with the very issue of sovereignty. In 2002 China and Asean signed a Declaration on the Code of Conduct of Parties in the South China Sea, but this is not a binding document. Up to now China has not possessed the

[91] Toshi Yoshihara and James Holmes, *Command of the Sea with Chinese Characteristics*¸ Foreign Policy Research Institute, Fall 2005

01_2006_4142_txt_EN.indd 63 12-07-2007 10:43:25

necessary capabilities and power projection to impose its dominance in South China Sea. However Western military analysts have noticed that the Chinese navy's expansion efforts have acquired significant momentum in the past few years. Since 2001 China has produced 23 new amphibious assault ships and 13 conventional attack submarines.[92] It seems that China's fleet will remain eminently regional with power projection to protect sea lanes of communication, to support claims over maritime disputed areas, to engage the Taiwan fleet, and to complicate any American intervention in the East Asian littoral. Furthermore China's navy modernisation and reinforcement will probably alarm the surrounding countries and other regional powers such as India and Australia and may lead to a region-wide naval forces renewal.[93] A number of Asian powers are already responding by developing military capabilities as a safeguard against China.[94]

The **East China Sea** is also a zone rich in natural resources and at the heart of a long-standing maritime dispute between China and Japan, which does not help to ease the increasingly tense political relationship between the two countries.

4.3.3.3.China and Japan: a tense relationship

The relationship between China and Japan is under severe strain and can be summed up as "cold politics, hot economy."[95] For the seventh consecutive year, Japan's trade with China hit a record high in 2005, reaching $189 billion. Nevertheless the political relations between the two nations, which are competing for regional leadership, have steadily worsened and nationalism is high on both sides between a Japanese "wounded nationalism" and a Chinese "assertive nationalism."[96] The two countries are at odds over wartime history, maritime resources and territorial disputes.

Prime Minister Junichiro Koizumi's repeated visits to the Yasukuni shrine since taking office in 2001 have been strongly criticised by China and – combined with the massive anti-Japanese demonstrations in major Chinese cities in the spring of 2005 – have harmed bilateral ties. The Yasukuni shrine is dedicated to about 2.5 million people who have died in Japan's wars from 1853 to 1945, including since 1978 fourteen convicted war criminals such as World War II Prime Minister Tojo Hideki. Beijing has refused to meet with Prime Minister Koizumi over the Yasukuni issue. Premier Wen Jiabao considers that the current tension "does not lie with China, nor with the Japanese people, but with the Japanese leader" and he believes that the "smooth development" of relations between the two countries would be difficult if the issue is not resolved.[97] The official Japanese position is that it is "erroneous" to view these visits as an attempt to glorify

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92 *Russia/China Convenient Allies*, Oxford Analytica Brief, October 11, 2005

93 Guiseppe Anzera, *The Modernization of the Chinese Navy*, Power and Interest News report, 22 December 2005

94 Ralf Emmers, *Maritime Dispute in the South China Sea and Diplomatic Status Quo*, Institute of Strategic Studies, Singapore, Working Papers 87, September 2005

95 Tomohoko Taniguchi, *A Cold Peace: The Changing Security Equation in Northeast Asia*, Orbis Vol. 49, Issue 3, Summer 2005

96 Byung-Joon Ahn, *The Rise of China and The Future of East Asian Integration*, Asia Pacific Review, Vol.11, Issue 2, 2004

97 Premier Wen Jiabao's press conference on 14 March 2006, the occasion of the closure of the National People's Congress, quoted by James J. Przystup, *Looking Beyond Koizumi*, Comparative Connections – A Quarterly E-Journal on East-Asian Bilateral relations, April 2006 – http://www.csis.org/images/stories/pacfor/0601qjapan_china.pdf

01_2006_4142_txt_EN.indd 64 12-07-2007 10:43:26

Japan's past militarism. The Prime Minister has stated clearly that the purpose of his visits to the shrine is to express respect and gratitude to the many people who lost their lives in the war, that he does not visit for the sake of the Class-A war criminals, and that Japan accepted the results of the International Military Tribunal for the Far East. He has acknowledged that Japan, "through its colonial rule and aggression, caused tremendous damage and suffering to the people of many countries, particularly to those of Asian nations."[98]

The Japanese leadership's concerns regarding China's military build-up and the maritime disputes between Japan and China provide further grounds for growing tensions. The 2006 Diplomatic Blue Book issued by the Japanese Ministry of Foreign Affairs emphasises the lack of transparency in China's military budget. In December 2004 the *Japan National Defence Guidelines* for the first time named China as a possible threat to Japan's national security and expressed strong concerns over China's military modernisation and the expansion of China's area of operations at sea. A long simmering maritime dispute opposes the two countries over the East China Sea, where their respective exclusive economic zones overlap. This situation is potentially volatile. Exploration of three natural gas fields and drilling rights are at stake. Japan and China base their respective claims on two different international covenants. This makes the case even more complicated.[99] Beijing and Tokyo keep holding a series of high level meetings to address their dispute, but not much has been achieved so far. The question is whether the two countries would be able to develop jointly the contested gas fields. The United States takes no formal position over the East China Sea dispute, though it is obligated under a security arrangement with Japan to defend Japanese forces should they come under attack.

Furthermore Prime Minister Koizumi has taken steps toward cementing Japan's alliance with the United States, a move strongly supported by the Bush administration. Japan and the United States have augmented their bilateral defence trade. The United States supports constitutional reform that could allow Japan's military to expand and be more active in the region, and importantly for the first time ever, Japan and the United States signed in February 2005 a joint statement that explicitly ties their bilateral alliance to peace and security in the region. China regards the enhanced cooperation between Japan and the United States as jeopardising its security interests and views Japan's claim for regional leadership as a throwback to imperialism.

As long as Koizumi is in office Japan-China relations are unlikely to improve, and China is already looking at the post-Koizumi future. Koizumi's tenure both as President of the ruling Liberal Democratic Party (LDP) and Prime Minister end in September 2006. However, from the Chinese perspective the end of the visits to the Yasukuni shrine will remain the *sine qua non* condition for any improvement in the relationship. President Hu gave that message clearly to a delegation of Japan–China friendship organisations led by

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98 Ministry of Foreign Affairs of Japan – Basic Position of the Government of Japan regarding Prime Minister Koizumi's Visits to Yasukuni Shrine (October 2005) – http://www.mofa.go.jp/policy/postwar/yasukuni/position.html

99 Under the UN Convention on the Law of the Sea, an exclusive economic zone can extend up to 200 nautical miles from a country's shoreline. The East China Sea between China and Japan is only about 360 nautical miles at its widest. Japan considers on the basis of the UN Convention that the boundary should be the median line between the two countries. China, which bases its claim on the 1958 Geneva Convention of the Continental Shelf (i.e. coastal countries are allowed to extend their borders to the edges of their undersea continental shelves) considers that its exclusive economic zone should extend to the edge of its continental shelf, which would put the line almost up against Japan's shores.

01_2006_4142_txt_EN.indd 65 12-07-2007 10:43:26

former Japanese Prime Minister Ryutaro Hashimoto, who visited Beijing in late March 2006 to exchange views on how to revive non-governmental contacts.

Some Japanese political figures and intellectuals have recently sent positive signals on the Yasukuni issue and the need to improve relations between the two countries. The new leader of the main opposition party, the Democratic Party of Japan, Ichiro Ozawa, has been very critical of Prime Minister Koizumi's China policy, including his controversial visits to the Yasukuni shrine. Ozawa has also criticised his predecessor's assertion that China posed a military threat to Japan. Kanzaki Takenori, leader of the new Komeito Party (NKP), i.e. the current LDP coalition partner, has expressed regret on several occasions over Koizumi's Yasukuni visits – a source of tension in the coalition – and has said recently that "Koizumi's successor must get down to the task of improving deteriorating relations with China and South Korea." Similar views have been expressed by the chief editor of the *Yomiuri Shimbun* and the chairman of the *Asahi Shimbun*'s editorial board in an unprecedented dialogue published in the February 2006 edition of *Ronza* magazine.[100]

Within the ruling LDP the two major contenders for the Premiership, Chief Cabinet Secretary Shinzo Abe (by far the most popular potential contender, according to opinion polls) and former Chief Cabinet Secretary Yasuo Fukuda, hold contrasting views on the Yasukuni issue. Shinzo Abe, who is known for his nationalist sentiments, has defended Koizumi's Yasukuni visits – nevertheless, he has recently adopted a more careful approach on this question – while Yasuo Fukuda has stepped up his rhetoric against Koizumi's shrine and called in March 2006 for improved relations with China and South Korea.

However, some observers wonder if the cessation of the visits to Yasukuni will actually change anything. James Mulvenon, deputy director of the Centre for Intelligence Research and Analysis in Washington, thinks that "China has too long relied on Japan's lack of historical veracity as a way to cover its own problems, and its own lack of an affirmative strategy for getting along with Japan." " If Koizumi suddenly stopped visiting the shrine, what would China do?" he asks. "I'm not sure Beijing knows."[101]

History may well continue for some time to get in the way of the Sino-Japanese relationship, yet any further deterioration in their cold political relations could become too much of a hindrance, not only for the two countries but for the whole Asia-Pacific region. In May 2005 China's Minister of Commerce Bo Xilai suggested a long-term Sino-Japanese cooperation deal based on energy and the environment. "If China and Japan can do better in the area of energy and environmental cooperation, Sino-Japanese relations will be pushed to a new platform", he said, drawing a comparison with the European Coal and Steel Community centred on France and Germany.[102]

4.3.3.4.China and India: the evolving relationship between two rising powers

China and India, the two oldest and still extant civilisations, are both developing very quickly, albeit with different approaches related to their respective historical economic

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[100] James J. Przystup, *op.cit.*

[101] Quoted by Robert Marquand, *Gulf Widens between Japan, China*, in The Christian Science Monitor, April 11, 2006 – http://www.csmonitor.com/2006/0411/p01s03-woap.html

[102] Weran Jiang, *China looks beyond Koizumi in its Japan Diplomacy*, China Brief, Volume VI, Issue 12, June 7, 2006 – The Jamestown Foundation

01_2006_4142_txt_EN.indd 66 12-07-2007 10:43:26

and political legacies. Actually India's path of development is totally unique. "India has relied on its domestic market more than exports, consumption more than investment, services more than industry, and high-tech more than low-skilled manufacturing." Indeed the "contrast between India's entrepreneur-driven growth and China's state-centred model is stark." [103]

China and India have had a difficult past, but it seems that both nations have decided to put it behind them. The turning point in Sino-Indian relations was marked by the then Indian Prime Minister Rajiv Gandhi's visit to Beijing in December 1988. On this occasion the Chinese leader Deng Xiaoping declared that "unless these two countries are developed there will be no Asian century", and added that "if China and India are developed we can say that we have made our contribution to mankind."

During this visit India and China signed an agreement to set up a Joint Working Group to defuse tensions along the border. More than fifteen years later, India still claims part of Chinese-controlled northern Kashmir and the Askai Chin area, while China disputes India's control over its north-eastern state of Arunachal Pradesh. However, the trend is definitely towards slow and pragmatic progress to reduce tensions between the two countries. For example, while China continues its military and political support to Pakistan, it also displays a more neutral stance on the Kashmir dispute between Pakistan and India; which pleases Indian policy-makers.

Undoubtedly the continued growth enjoyed by both countries is a strong incentive for China and India to move towards a more stable relationship and to develop a pragmatic form of cooperation conducive to increased bilateral trade (where the potential is huge). India accounts for nearly 80% of South Asian economic activity, and trade between China and India has gone from $332 million in 1992 to $13.6 billion in 2005. Moreover the two countries share the aspiration of a multipolar world which will take greater account of their role. Both China and India are trying to position themselves not only as major economic powers but also as major political powers in Asia.

The warming in China-India relations does not mean that it will be an easy partnership. The two nations are competing in a number of areas, in particular in their simultaneous quest for energy, a strategic priority for both India and China. The two nations are two of the largest, fastest-growing energy consumers in the world. During his visit to Beijing in January 2006 the Indian oil Minister, Mani Shankar Aiyer, signed an agreement to cooperate with China in securing crude oil resources overseas and hence try to prevent fierce competition for energy resources. However, "before the ink was even dry on the Beijing agreement, Indian oil ministry officials found out that Myanmar has agreed to sell natural gas from a field partly owned by an Indian company exclusively to China."[104]

China and India are also closely following each other's naval ambitions. India is worried about an increased China's presence in the Bay of Bengal and in the Indian Ocean. For both countries it is a vital national interest to modernise their naval forces for securing shipping lanes and thereby ensuring that their respective energy supplies will not be interrupted.

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[103] Gucharan Das, *The India Model*, Foreign Affairs, July/August 2006

[104] Michael Vatikiotis, *India and China: A Delicate Dance*, International Herald Tribune, 24 January 2006

01_2006_4142_txt_EN.indd 67 12-07-2007 10:43:27

India is pursuing a strategic partnership with the United States, which may sometimes provoke tensions with China For example, the recent US-India nuclear deal on civil nuclear cooperation was finalised during President Bush's visit to New Delhi in March 2006 and was promptly harshly criticised by Beijing without waiting for Congress's final decision on the future of a deal which is widely regarded as having been concluded in great haste. As China in the past helped Pakistan to develop the missile technology that enabled Islamabad to get its nuclear weapons, India is now worried that China's reaction may be "a pledge to supply Pakistan with new nuclear technology."[105] Actually several security experts consider that stepping up Indian production of fissile materials "could lead to increased tensions and destabilising arms competition in southern Asia, involving India, Pakistan and China."[106]

Finally, while Asia looks towards its leading powers, China, Japan and India, to promote stability and prosperity in the region, the relationship between the three is far from harmonious. For many observers Japan is trying to foster its ties with India to counter what it sees as the growing strategic threat from China.

Still, whatever tensions persist in China-India relations it seems probable that their parallel development "will shift the global centre of gravity closer to Asia than any time since the 18th century."[107] What is at stake with the improvement of China-India relations is not only an enhanced economic development in the two countries but also, and as importantly, economic development and stability in the broad region. Both countries need each other to achieve those objectives and they would certainly prefer to maintain their current *modus vivendi*. The Indian Foreign Secretary Shyam Saran recently declared that India and China "are too big to contain each other or be contained by any other countries", and in this context both countries are shaping a "strategic and cooperative partnership for peace and prosperity."

4.3.3.5. The United States' and China's influence in the region

Most observers agree that the most important relationship in the region with truly regional and global implications is the Sino-American one. The United States has for a long time been a dominant actor in the region, it has substantial economic interests and numerous security commitments: five of the seven United States mutual defence alliances are in Asia. The US-led regional security architecture remains the predominant one. It is the so-called "hub and spokes" system – the United States being the hub, and Australia, Japan, South Korea, the Philippines and Thailand the spokes – which has delivered stability and security to the region since the Cold War and has smoothed the progress of Asia's economic development.

Today a number of Asian nations complain that in the past few years the United States has been excessively focused on terrorism and on bilateral relations as against the multilateral relationship. As a result the United States' influence in the region is on the decline. That is the case in South-east Asia, where the United States' influence is

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[105] Michael Vatikiotis, *op.cit* .

[106] "Testimony before the Senate Foreign Relations Committee, "The U.S.-India Civil Nuclear Deal", 26 April 2006. A statement by Robert J. Einhorn, Senior Adviser, Centre for Strategic and International Studies.

[107] H.E. M.K Narayanan, National Security Adviser, India, *China and India: the Asian Rising Powers Debate: an Indian Perspective*, The 3rd Global Strategic Review Conference of the International Institute for Strategic Studies, Geneva, 18 September 2005

01_2006_4142_txt_EN.indd 68 12-07-2007 10:43:27

decreasing while China's is rising. In South Asia, both the United States' and China's influences are on the rise, and in Central Asia, the American presence has been strengthened in the aftermath of September 11, while China's influence is also on the rise.

However, a number of regional players continue to welcome the United States' presence including as a security guarantor. Besides, the United States remains an economic partner of choice for the region and is not a threat to many manufacturers in Asia, while China is. Furthermore, China's lack of transparency in addressing transnational issues is a continued source of concern among other regional players, with many seeing China as a source of a number of non-military challenges such as environmental (for example 13% of acid rain depositions in South Korea, 17% in Japan and 39% in Vietnam come from China), or health problems (see the SARS crisis and its regional economic implications, especially in the tourist industry).

Asian leaders are naturally reluctant to choose between China and the United States. They are "torn between their long term concerns over a bullying United States, a hegemonic China and a resurgent Japan. (They) seem to be eager to maintain an identity independent of Japan, China and the United States", and officials from Asean member states indicate that Asean gives them the chance to talk on a more equal footing with the potential hegemons.[108]

4.3.3.6. The first East Asia Summit and the competition for regional leadership

The first East Asia Summit held in Kuala Lumpur in December 2005 perfectly mirrored the complexity of a region that is undergoing profound changes. The United States did not join the Summit. It refused to sign the Treaty of Amity and Cooperation (TAC), one of the three conditions for participation in the Summit.[109]

Chinese Premier Wen Jiabao explained at the 2004 Asean summit that China had embraced Asean + 3 as a road towards the creation of an East Asia Community; "a long-term strategic choice in the interests of China's development." Obviously the way the first East Asia Summit unfolded did not fit China's preferred choice for a future East Asia Community. The membership of the Summit (Asean + 3, Australia, New Zealand and India) was the subject of disputes, notably over the participation of Western-oriented countries. As originally conceived by Malaysia and supported by China, the East Asia Summit was to include Asean countries plus China, Japan and South Korea ("Asean + 3" format). Japan, joined by Indonesia and Singapore, led the fight to include Australia, India and New Zealand. The participation of Australia and New Zealand in particular was seen as ensuring that Asean would remain at the centre of any emerging East Asia Community. Furthermore the Kuala Lumpur Declaration of 14 December 2005 made it clear that future summits would be held only in Asean countries, while China had suggested hosting the next meeting. As the chance of China leading an East Asia

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[108] Elizabeth Economy, *China's Rise in Southeast Asia: Implications for Japan and the United States*, Japan Focus, October 10, 2005

[109] For some analysts the American absence was short-sighted. Jusuf Wanandi, a scholar of the Centre for Strategic and International Studies in Indonesia, expressed concerns about the lack of a United States' policy on the region. "I know about the mess in the Middle-East, but don't be distracted", he says, "this is definitely whether you like it or not, the most important region for the future." According to him Asia needs the United States both as a balancing force and an economic power. In Seth Mydans, *Asian Leaders Search For Common Interests in America Absence*, The New York Times, December 15, 2005

01_2006_4142_txt_EN.indd 69 12-07-2007 10:43:27

Community some time in the near future waned, so China's enthusiasm for the summit cooled down.

An Eminent Person's Group will work out an Asean Charter to be discussed at the next Summit. They will undoubtedly have to balance the priorities of the more advanced and the less advanced Asean members. However can an East Asian Community take off effectively if Asia remains split, and China and Japan do not normalise their relationship? "After all, politics still takes precedence over economics, in Asia in particular."[110]

4.4. China's "go global" energy policy

China's limited progress in accessing local energy resources due to the maritime disputes over the East China Sea and the South China Sea, and the growing instability in Central Asia, have pushed the country to search for energy abroad in Africa, the Middle East and Latin America. Between 2002 and 2004, 65% of the countries (excluding the United States and Europe) visited by the top Chinese leadership were oil producers, and 72% were exporters of oil and of important natural resources. The main driver here is obviously economic. However, some aspects of China's quest for energy resources raise specific concerns. China's pragmatic approach to international relations, based on the principle of non-interference in domestic affairs, gives little room to other considerations such as the political situation of the energy exporting country. This may have a potential destabilising effect on regional security and may undermine China's own efforts to be seen as a responsible global power.

When courting energy exporters, China has a number of advantages: (i) China is not a colonial power, (ii) China has not laid out a vision or a policy to transform some regions, (iii) China is a huge market and magnet for investments, and (iv) China has been willing to engage with those countries that the international community and in particular the United States have sought to isolate.

4.4.1. Africa

China's trade relations with Africa are growing fast, as Chapter 3 has shown. This is mainly resource seeking. China now gets about 30% of its oil from Africa (mainly from Sudan, Angola and Congo-Brazzaville). China has found in Africa a number of business partners in countries where many Western nations have been reluctant to engage.

A 2006 White Paper outlines China's policy objectives in Africa, stressing that the relations – as are China's relations with any other country – are based on the Five Principles of Peaceful Coexistence and the One China policy. The document can be seen as a response to criticism of neglecting political realities. It presents four general principles and objectives of China's African policy:

- *Sincerity, friendship and equality*. China adheres to the Five Principles of Peaceful Coexistence, respects African countries' independent choice of the road of development, and supports their efforts to grow stronger through unity.

- *Mutual benefit, reciprocity and common prosperity*. China supports African countries' striving for economic development and nation building, is intent on

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[110] Eric Teo Chu Cheow, *East Asia Summit: Big Power Rivalry But No Integration*, The Nation, December 14, 2005

01_2006_4142_txt_EN.indd 70 12-07-2007 10:43:27

cooperation in various forms in economic and social development, and promotes common prosperity of China and Africa.

- *Mutual support and close coordination*. China will strengthen cooperation with Africa in the United Nations and other multilateral systems by supporting each other's just demands and reasonable propositions and continue to appeal to the international community to give more attention to questions concerning peace and development in Africa.

- *Learning from each other and seeking common development*. China and Africa will learn from and draw upon each other's experience in governance and development, and strengthen exchange and cooperation in education, science, culture and health. Supporting African countries' efforts to enhance capacity building, China will work together with Africa in exploring ways towards sustainable development.

China is an attractive partner for many African countries. A China Africa Cooperation Forum was created in Beijing in 2000 to promote trade and investment with 44 African countries. The forum provides a venue for Sino-African consultations and dialogue. China's non-interference in domestic affairs satisfies leaders whose countries are characterised by poor governance and opaque political systems. Those leaders are ready to give full support to China while they are reluctant to implement the kind of demanding economic or political reforms required by the Western donors. That is the advantages of the "Beijing consensus" over the "Washington consensus."[111] Political or economic reforms are not seen as indispensable for long-term sustained development. China has successfully exported its notion of economic development with Chinese characteristics, encouraging its African trading partners to develop their economies through trade and investment in infrastructure and social institutions, without dictating terms of political or economic reforms.[112]

This situation creates a collusion of interests that may hinder the proper functioning of multilateral organisations. Ethiopia and Eritrea are voting members of the former United Nations Commission on Human Rights – now the UN Human Rights Council – until 2006 and Sudan until 2007. In 2004 the United States and other Western countries were blocked in their efforts to censure China for its human rights record, with Sudan, Ethiopia and Eritrea all siding with China in the Commission. In the summer of 2004 the then Chinese Deputy Foreign Minister Zhou Wenzhong said about Sudan that "business is business. We try to separate politics from business", adding that "the internal situation in the Sudan is an internal affair, and we are not in a position to impose upon them".[113] In September 2004, China watered down a United Nations resolution condemning Khartoum over the Darfur crisis. In November 2004 China signalled its opposition to the

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[111] Joshua Cooper Ramo cited by Drew Thompson, *China's Soft Power in Africa: From the Beijing Consensus to Health Diplomacy*, China brief, The Jamestown Foundation, Vol. V, Issue 21, October 13, 2005

[112] According to He Wenping, director of the African Studies Section at the Chinese Academy of Social Sciences (CASS), China and Africa "share the view that countries should not meddle in each other's affairs. 'We don't believe that human rights should stand above sovereignty', says He. 'We have a different view on this, and African countries share our view." See Paul Mooney, China's African Safari, Yale Global Online, 3 January 2005 – http://yaleglobal.yale.edu/article.print?id=5106

[113] David Zweig and Bi Jianhai, *China's Global Hunt for Energy, RealClear Politics*, September 6, 2005. http://www.realclearpolitics.com/Commentary/com-8_25_05_DZ_pf.html

01_2006_4142_txt_EN.indd 71 12-07-2007 10:43:28

United States' call to refer the issue of the Iranian nuclear programme to the United Nations Security Council.

The greater danger is that China might trade certain weapons and technologies for access to energy.[114] China is currently the world fifth largest arms supplier. China, which is now Sudan's main oil trading partner, has supplied Sudan with fighter aircraft and diverse weaponry. China has also provided military training in Equatorial Guinea, and has been involved as well in Ethiopia and Eritrea with military cooperation and arms sales, while world leaders are worried about a new conflict in the region, with tensions rising along the border between Ethiopia and Eritrea.

China-Zimbabwe military ties are among the closest on the African continent. In late 2004, President Mugabe ordered fighter jets from China (an order worth $200 million) and a hundred military vehicles, a move that displeased South Africa. Many political analysts fear that such transfers could spark an arms race in Southern Africa. In December 2003, Premier Wen Jiabao declared that "China respects and supports efforts by Zimbabwe to bring about social justice through land reform"; indeed, China has secured the contracts to develop Zimbabwe's agricultural, mineral and hydroelectric resources. Zimbabwe's vast mineral and precious metal deposits are fairly attractive to China.

Beyond energy policy, trade relations and arms deals, the Sino-African relationship is also an opportunity for China to boost its soft power. China is keen to promote China studies and Chinese language training in Africa and seeks to establish "Confucius Institutes" in Africa programmes at leading local universities. Moreover African students are welcome in China. In 2003, 1 793 African students studied in China, i.e. one third of total foreign students that year. China plans to train some 10 000 Africans per year, "including many future African opinion leaders who once might have trained in the West." [115]

Box 4-3: China and the developing world

China's track record on protracted high levels of economic growth makes it an interesting case study for other developing countries. China itself regards its own development path as a model for other countries to consider. China's economic weight is also increasingly felt by other developing countries. Some countries have been seriously squeezed, with China out-competing them not only on the export markets but also competing with home-produced goods in domestic markets. Many have benefited handsomely, though, in terms of China's rapidly increasing imports. China has had a particularly voracious appetite for energy sources. China's quest to secure energy has highlighted how its actions may sometimes clash with international norms.

China is increasingly contributing financial investments and aid to other developing countries. These investments are often linked to its energy needs. When providing assistance, China does not base it on conditionality. This is in line with China's long-standing opposition to external interference in internal affairs.

This has positive sides, as the receiving countries have wide discretion to use funding according to local needs. Moreover, the investments funded by China may in theory improve the recipient country's economic wealth and growth potential. However, experience shows that aid and investments only

[114] Information on arms sales to Africa comes from Joshua Eisenman, *Zimbabwe: China's African Ally*, China Brief, Vol. V, Issue 15, July 5, 2005 – Ian Taylor, *Beijing's Arms and oil Interests in Africa*, China Brief, Vol. V, Issue 21, October 2005 – David Shinn and Joshua Eisenman, *Duelling Priorities for Beijing in the Horn of Africa*, China Brief, Vol. 5-21, October 13, 2005

[115] Joshua Eisenman and Joshua Kurlantzick, *China's Africa Strategy*, Current History, May 2006, pp.219-224

01_2006_4142_txt_EN.indd 72 12-07-2007 10:43:28

contribute to long-term development if the political and economic institutional environment favours development. Many of the countries where China is active (e.g. Zimbabwe, Sudan, Myanmar) have been cut off from international assistance precisely due to deficiencies in this respect, be it due to a history of corruption, bad governance or political oppression. Therefore, while China's non-conditional development aid may yield dividends in the short term, it may not be in China's long-term interest as the funding may undermine recipient countries' long-term development by handing a lifeline to regimes which are otherwise cut off from international assistance.

International norms for development assistance exist. They are there for a reason: to ensure that development assistance contributes to long-term development. By choosing to ignore the institutional setting/internal political situation in the countries where China is present, China makes these international norms less effective. More importantly from a Chinese perspective: while short-term interest in terms of energy needs may well be met, by not considering the broader environment the long-term development of the recipient countries may well be undermined.

4.4.2. Middle East

More than 45% of China's oil imports were estimated to come from the region in 2004. Iran alone already accounts for about 11%, and in October 2004 SINOPEC, China's second largest oil company, signed an oil and natural gas agreement with Tehran that could be worth as much as $70 billion – China's biggest energy deal yet with any major OPEC producer.[116] Iran has obvious political and strategic advantages in cultivating closer ties to China, as Tehran comes under increased international pressure over its nuclear activities. The new Iranian President Ahmadinejad has spoken openly about the imperative for Iran to forge strategic alliances with strong non-Western countries such as China.

China attempts to improve its relations with its already established oil suppliers – Saudi Arabia and Iran – by selling them military technology, and investing in their industries and energy infrastructures. Furthermore China has also institutionalised its relations with the Middle East through mechanisms such as the newly established China-Arab Cooperation Forum.

4.4.3. Latin America

By making inroads in Latin America, China is entering the United States' traditional sphere of influence. The United States is looking closely at China's interference in a region that has traditionally been within its sphere of influence and a major energy supplier. Venezuela and Canada together provide the United States with a quarter of its energy imports; Venezuela sells 60% of its crude oil to the United States and is the US's fourth largest oil supplier. For Latin America's energy producers, China therefore offers an opportunity to diversify exports.

The Sino-Latin American relationship is predominantly driven by economic interests. Latin America's share of Chinese imports grew from 2% in 1990 to 4% in 2004, and its share of Chinese exports from 1% (1990) to 3% (2004), while China's share of Latin American exports are 6 to 10 % in 2003 up from 1 to 4% in 1999.

In Venezuela, for example, China has invested heavily in oil fields, gas projects and upgrading the country's rail and refinery infrastructure. China is also acquiring oil in Brazil and Ecuador, and is investing in Argentina. China buys vast quantity of iron, bauxite, soybeans, timber, zinc and manganese from Brazil, tin from Bolivia, and copper from Chile.

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[116] David Zweig and Bi Jianhai, *op.cit*

01_2006_4142_txt_EN.indd 73 12-07-2007 10:43:28

In November 2004, during his visit to Latin America, President Hu secured a market economic status from Brazil, Argentina and Chile in exchange for pledging to invest $100 million in Latin America for the next decade and reducing restrictions on Latin American products entering the Chinese market. In January 2005, Chile and China began discussions on an FTA. Brazil is also pushing for the creation of a FTA with China.

Overall, China may be benefiting from long-standing unease and increasingly critical views on the level of US regional influence held by a number of administrations currently in power (e.g. Hugo Chavez's Venezuela, Fidel Castro's Cuba, Nestor Kirchner's Argentina, Eva Morales' Bolivia and even Lula da Silva's Brazil). However, China remains very cautious about its involvement in this U.S. sphere of influence.

China's involvement in Latin America is also a way of exerting some leverage on a number of countries which have recognized Taiwan diplomatically (12 out of the 26 countries maintaining diplomatic ties with Taiwan are in Latin America).

4.5. Conclusion

China's trading and diplomatic role in Asia is increasingly important, and regional interdependence is probably conducive to a more stable environment. But it is too early to say if China will become the Asian leading power. The United States remains an important player in the region and is welcomed as such by a number of countries. Furthermore China's growing importance in the region is not free of risks, and the neighbouring countries are directly exposed to the adverse consequences of China's economic rise, worsened by Chinese tendency to a lack of transparency. That means that China's neighbouring countries will be better off if China solves its own domestic problems in an acceptable way and if they keep a balance to China's rising power in the region through their relations with the United States, and for South East Asia, through Asean playing a more assertive role.

The relations between the Asian countries are based on the Five Principles for Peaceful Coexistence, which include respect for sovereignty and territorial integrity. But the region is very unstable, with hot spots such as Taiwan and maritime disputes over areas rich in energy. In this context China's military modernisation is of concern for its neighbours and may lead to a potentially destabilising armament race.

China's development and assistance policy towards a number of countries, especially in Africa, may alleviate some of the problems encountered by those countries. But, as it does not pay much attention to political reforms, it may also pose a risk of undermining the capacity of the international community to influence countries in the direction of good governance, human rights and political freedom.

01_2006_4142_txt_EN.indd 74 12-07-2007 10:43:29

PART II: WHAT CHALLENGES IS CHINA FACING?

As the previous chapters have shown, the economic success of China's post-Maoist development strategy is evident. For two and a half decades the Chinese economy has been growing at truly remarkable rates and has now assumed an important position in the world economy. In a number of sectors, China has caught up with the global technology frontier and is now entering into a new phase of growth, relying more on indigenous innovative capacity.

The remaining objectives, though, are daunting. Pulling all of China's population out of poverty is an endeavour requiring sustained high growth for a long period of time. Moreover, China's long-term growth strategy, as laid out in its 11th five-year Plan (2006-2010), calls not only for more wealth, but for a "harmonious" society where wealth is more evenly distributed and where growth is based on technology, economic efficiency and low consumption of natural resources.

While growth remains high, are the foundations sufficiently sound to deliver this vision? Despite the impressive scope of past reforms, challenges clearly remain. In order to meet them, not only do the reforms agreed upon so far need to be implemented on the ground; reforms also need to be broader and deeper. A number of areas warrant particular attention in this respect and are elaborated upon in this part.

- *Securing a balanced macro-economic environment (chapter 5),*
- *Upgrading the financial system (chapter 6),*
- *Reforming the public and private production system (chapter 7),*
- *Refocusing public finances (chapter 8),*
- *Developing China's innovative potential (chapter 9),*
- *Absorbing surplus labour (chapter 10),*
- *Addressing the increase in inequality (chapter 11),*
- *Addressing the environmental challenges (chapter 12),*
- *Adapting China's political and legal system to a transformed society (chapter 13).*

Overall, the biggest challenge for China is that the challenges cannot be tackled one-by-one. Instead, they need to be dealt with together: failure to overcome the economic challenges may increase the risks of internal political dissent; failure to overcome the political and social challenges could have adverse economic consequences. Despite the massive scope of the challenge ahead, but taking into account China's past determined development path, it would be naïve to doubt that China will not be progressing towards its targets and making the most of its strengths.

01_2006_4142_txt_EN.indd 75 12-07-2007 10:43:29

5. SECURING A BALANCED MACRO-ECONOMIC ENVIRONMENT

The diverse forces that will impact on China's economy as a result of trade and investment liberalisation and the restructuring of the domestic economy will place heavy demands on China's macroeconomic policy instruments. As the earlier discussion suggests, macroeconomic policy will need to be able to support higher real GDP growth in order to create employment, without fuelling inflation.

Table 5-1: Macro-economic fundamentals in China

	2003	2004	2005	2006
Real GDP growth	9.5	9.5	9.0	9.2
Inflation (CPI)	1.2	3.9	4.0	4.0
Fiscal balance (% GDP)	-1.9	-0.9	-0.4	-0.2
Current account balance (US$bn)	45.9	68.7	100.0	101.0
Current account balance (% GDP)	3.1	4.0	5.2	4.6
Foreign exchange reserves (US$bn)	403.2	609.9	769.0	..

Source: OECD (2005), ECB (2006).

A first macroeconomic policy area is *improving the effectiveness of monetary policy* in managing aggregate demand. An important weakness – the poor financial conditions of enterprises and of banks that are responsible for the present credit crunch – is likely to take some time to remedy fully, as will be discussed below. However, interest rate liberalisation is important too. Restrictions on bank loan rates limit the ability of central bank operating instruments to control the effective cost of credit to final borrowers. Interest rates in the inter-bank market have been freed, and in October 2004, the ceiling of the floating bank rate band was abolished, enabling China's banks to price credit risk better. In practice however, banks have been slow to utilise fully their new autonomy, stressing the complementarity with reforms in the financial sector (see Chapter 6).

A second objective is to *accelerate the development of the government bond market* in order to accommodate the large increase in government debt that is likely to be needed over the next few years (see Chapter 8). As the stock of debt grows, it will be increasingly important to broaden access by domestic institutional investors and, at a suitable point, to allow foreigners to purchase government bonds. Development of the money market and liberalisation of bank loan rates is also important to bond market development, to help securities dealers to fund inventories of government bonds.

The third challenge is *to progressively increase the flexibility of the exchange rate and capital control regimes*. Ultimately, a floating exchange rate regime may well be best suited to China's conditions (see Box 5.1), in part because it will allow for more independent monetary policy once the capital account is liberalised. Progressive liberalisation of the capital account will be needed to allow domestic businesses sufficient access to international financial markets as trade and investment liberalisation progresses, and to help spur the development of domestic financial markets. Identifying the steps needed to balance these considerations is very difficult. The risks of premature liberalisation are especially great in China because of the poor financial conditions of enterprises and financial institutions, weak corporate governance, and the incomplete development of the financial supervisory and regulatory system, as will be detailed below. In the short term, the stability afforded by the present exchange rate regime is probably beneficial to China's economy, but there is also a need to establish a foundation for greater flexibility in the future.

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Box 5-1: What is the "fair" value of the Renminbi?

China's increasing bilateral trade balances with the triad economies and the fact that it is depreciating in tandem with the US dollar against other currencies have sparked an intense discussion on the "fair" value of the Renminbi and its revaluation potential. Some observers claim that China clings to an undervalued currency which provides it with "unfair" advantages in global trade. While some authors see no case for a revaluation at all (Bosworth, 2004), others see the Renminbi as undervalued by as much as 40% or even more (Credit Suisse First Boston, 2003, Nomura Research Institute, 2003). The July 2005 revaluation of the currency by 2.1% represents a small step in the direction of greater flexibility in the exchange rate. But what is the "fair" value of the Renminbi?

To begin with, the concept of a "correct" and "fair" exchange rate is highly complex. While several quite diverse conceptual frameworks exist to evaluate "equilibrium" exchange rates, no approach can claim to be able to accurately pinpoint such a rate. Analyses based on the purchasing power parity (PPP) approach attest the Renminbi to be undervalued. The United Nations' International Comparison Project even comes to the conclusion that the equilibrium exchange rate for the Renminbi would be 1.74 RMB / 1.00 US$. In order to reach this value the Renminbi would have to revalue considerably. This approach, however, is based on absolute PPP and does not take into account the different levels of development of the economies being compared. Adjusting for this effect, the Renminbi would be seen as undervalued (Nomura Research Institute, 2003, Bosworth, 2004).

Very different conclusions can be drawn from analyses focusing on the economic fundamentals underlying economic development in various countries. Most frequently employed by the IMF, this approach puts the external balance (current account position) into perspective with the internal balance (medium-term saving to investment position). Per Bosworth (2004) China does not have an undervalued currency according to this methodology. In his analysis China's present domestic saving-investment balance conforms with the existing comparatively small current account surplus. The Renminbi should therefore be regarded as more or less correctly valued. Given its high savings rate, any deviation from the status quo by revaluing the Renminbi in order to attain a current account deficit, which is the standard recipe for developing economies, is not viewed as a suitable policy for China.

An analysis based on the "fundamental equilibrium exchange rate" (FEER) approach, which is closely related to the IMF methodology, however, may indicate an undervaluation of the Renminbi. Williamson (2003) argues for a revaluation of the Renminbi in a range of 20-30%. His assessment, however, is based on the notion that China should strive for a current account deficit of about 1% of GDP.

A fourth approache is based on the notion that "excessive" foreign exchange reserves are an indicator of an undervalued currency. With its large and rapidly growing foreign exchange reserves China seems to be the perfect revaluation candidate viewed from this methodological perspective. However, with an import cover of 11-12 months, foreign exchange reserves are not excessive in an international perspective. Other Asian economies like Japan and Taiwan feature import covers of up to 20 months.

Irrespective of whether the Renminbi should revalue or not, a comprehensive reorganisation of China's exchange rate regime can be expected. At the moment China operates a managed float system which in practice, however, functions like a fixed peg. In the long term China has agreed to move to a floating exchange rate system. This however seems to be far away and cannot be achieved before China's financial system has undergone a comprehensive restructuring and it appears "safe" to introduce capital account convertibility.

01_2006_4142_txt_EN.indd 77 12-07-2007 10:43:29

6. UPGRADING THE FINANCIAL SYSTEM

A sound financial system is vital for the smooth functioning of an economy. A well functioning financial system plays a crucial role in facilitating the allocation of resources.

The banking sector is the dominant intermediary of finance in China. Financial intermediation in China is controlled by the state. The banking system is dominated by the four State Owned Commercial Banks (SOCBs)[117]. Even though capital markets have been growing rapidly in recent years, the equity and bond markets remain small. Moreover, the financial system suffers from the virtual absence of institutional investors.

China is fortunate to have one of the highest savings rates in the world.[118] But the way these savings are used leaves a lot to be desired. Banks have traditionally focused their lending on large State Owned Enterprises (SOEs) and other players favoured by industrial policy. While banks have been encouraged to spread their lending, many private firms continue to suffer from inadequate access to finance. This lack of finance for investments acts as a brake on Chinese private firms growing to a larger, internationally competitive, scale (see Chapter 7).

Moreover, as SOEs have run into financial trouble, so has the banking system, which explains why the reform of SOEs (see Chapter 7) and financial sector reforms are closely linked. By the mid-1990s most of China's banks were plagued by Non-Performing Loans (NPLs) and as a consequence technically insolvent. Significant capital injections and reforms to the way the banking sector operates have been undertaken or are under way. Even though this has more or less restored the SOCBs to minimal levels of solvency, the banking system overall remains in a precarious financial state.

At the root of many of the financial system's current ills is that financial intermediation – be it via banks or capital markets – has for long been subordinated to industrial policy needs. The state's influence remains pervasive. The government continues to use the banking system to subsidise ailing SOEs and pursue special policy objectives which continue to lead to non-performing loans. Even though reforms have been undertaken and more are under way, the core challenge is to enable intermediaries to act commercially.

Faced with these problems, Chinese authorities have invested significant energy in upgrading the country's financial system. Apart from addressing the financial position of the banking system, the authorities are trying to develop their capital markets by updating regulatory structures and stimulating the development of supporting institutions. However, more is needed to put the financial system on a sounder footing so that it can be more effective in supporting growth.

6.1. Bank finance

The banking sector in China currently offers a mixed picture of modern elements mixed with remnants from the time of central planning. It is dominated by four large state-

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[117] Bank of China, China Construction Bank, Industrial and Commercial Bank of China, Agricultural Bank of China.

[118] The high savings rate of the Chinese can to a large extent be attributed to precautionary savings for health, pension and education, in view of the poor public provision.

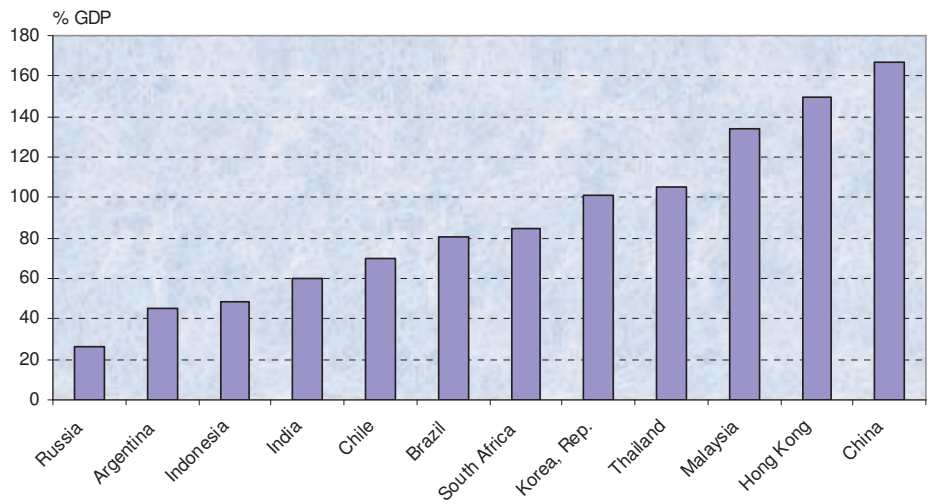
01_2006_4142_txt_EN.indd 78 12-07-2007 10:43:30

owned commercial banks. These built up an impressive volume of non-performing loans in the 1990s. The authorities have gone a long way to addressing the stock of these loans, in the process restoring some of the leading banks to minimal levels of solvency. To dilute the impact of NPLs in the current SOEs portfolio, the volume of new loans is being stimulated. At the same time the governance of the SOEs needs to be improved to decrease the risk of new bad loans being granted. Bringing "strategic investors" and foreign banks into the ownership of SOEs should introduce the necessary expertise, capital and discipline to improve governance.

6.1.1. A large and growing banking system

As illustrated by the graph below, banks play a very dominant role in financial intermediation. Credit provided by the banking sector amounted to nearly 170% of GDP in 2004. This is more than in other emerging economies.

Figure 6-1: Domestic credit provided by banking sector (% of GDP, 2004)



Source: World Bank Development Indicators (2005).

Another characteristic of the Chinese banking system is the exceptional level of state involvement. There has so far been very little privatisation, and the foreign presence also remains limited. While China had one bank only prior to 1978, there are now four major types of banks: (i) the State Owned Commercial Banks (SOCB), (ii) the Joint Stock Banks (JSB), (iii) the Rural Commercial Banks (RCB) and (iv) the City Commercial Banks (CCB). Despite this variety of banking institutions, the Chinese banking system is very concentrated, with the four SOCBs accounting for the majority of credit intermediation.

Bank lending has grown very fast in recent years. One reason is that as the Chinese economy is growing rapidly, there is little alternative – domestically or, for that matter, internationally – to bank financing for Chinese companies in need of capital. Moreover, banks have recently started to move into new business lines as the Chinese economy develops (e.g. home financing and consumer credit).

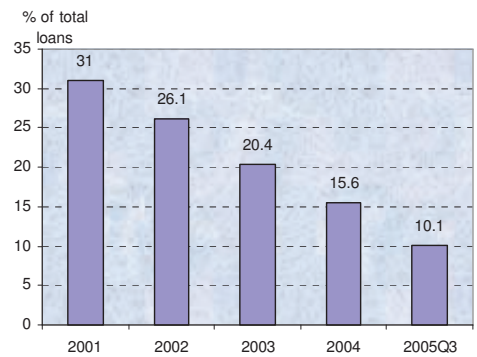
01_2006_4142_txt_EN.indd 79 12-07-2007 10:43:30

Banks have traditionally been government agencies and have played an important role as vehicles of industrial policy. Up until the 1990s, they were particularly encouraged to lend to State-Owned Enterprises (SOEs). However, during recent years there has been a move towards market principles, with market liberalisation and opening and increasing competition. The challenges that the banking system is facing are partly related to past misdemeanours and partly to the need for further institutional changes to enable the banking system to perform in a more market-driven environment. Even so, the build-up of lending to the real estate sector in recent years is another example of how banks have been used to support political objectives (in this case housing reform).

6.1.2. Addressing precarious financial positions[119]

The past (and present) role of banks was (is) to act as a vehicle for industrial policy, i.e. extend credit not on commercial but on political considerations. Banks were for a long time encouraged to support SOEs. When these ran into problems in the 1990s, the government encouraged further lending. The crisis duly spread to the banking sector, leading to a build up of risky and ultimately non-performing loans.

Non-Performing Loans of State Owned Commercial Banks as share of total loans



Source: China Banking Regulatory Commission and OECD (2005).
Note: figures for 2001 and 2002 follow old classification, 2003 and forward follow new five part classification.

By the mid-1990s the banking sector was basically insolvent, as Non-Performing Loans (NPLs) greatly exceeded equity. This was especially the case for the SOCBs, where bad loans according to unofficial estimates exceeded 50% of outstanding loans. While Joint-Stock Banks were less exposed, City Commercial Banks and especially Rural Commercial Banks were seriously affected. Related to the bad loans, Chinese banks also had low levels of capital and little provisioning.

The reasons for the bad financial positions were partly beyond the control of banks. Outside interference by the government encouraged excessive lending to SOEs. Moreover, once in a situation of having to argue for loans to be repaid, the banks were faced with limited legal means to enforce loan agreements. However, the banks also helped to make the situation worse. They had very weak internal loan assessment and risk management systems, poor corporate governance and an antiquated loan classification system.

To correct this state of affairs, the Chinese authorities adopted a two-pronged approach. A first wave of measures to address NPLs was started in 1998 with a capital injection amounting to 3.5% of GDP. This was followed in 1999/2000 by a transfer of some NPLs – amounting to 14% of GDP – to four bank asset management companies. A second, and more comprehensive, wave of measures to address remaining NPLs was launched in 2003. That year, authorities injected a further US$45bn into two state-owned commercial banks (BOC, CCB). This was followed in 2005 by a capital injection of US$15bn into

[119] This section builds heavily on IMF (2004) and OECD (2005).

01_2006_4142_txt_EN.indd 80 12-07-2007 10:43:30

ICBC. Apart from more capital, banks have been allowed to set interest rates more freely – and hence price risk more accurately. In addition, the heavily taxed banks have seen their tax burden scaled down somewhat, as the business tax on gross income (on top of the 33% corporate income tax) has decreased from 8% to 5%. As a result of these reforms *and increases in lending* (which *ceteris paribus* decreases the NPL share of total loans), NPLs have decreased substantially. However, the profitability of banks, though positive, remains low by international standards.

Table 6-1: Profitability of Chinese and international banks (end 2003)

Bank	Total assets (US$bn)	Return on assets (%)	BIS capital ratio	NPL/total loans (%)
Bank of China	464	0.3	7.0	16.3
Industrial and Commercial Bank	638	0.1	5.5	21.2
China Construction Bank	429	0.0	6.5	9.1
Agricultural Bank of China	360	0.1	..	30.1
Bank of Communications	115	0.0	7.4	13.3
HSBC (Hong Kong)	277	1.6	12.1	2.3
Citigroup (US)	1264	2.1	12.0	2.7
JP Morgan Chase and Co (US)	771	1.3	11.8	1.5
Mizuho Financial Group (JP)	1285	0.7	11.4	4.8
Mitsubishi Tokyo Financial Group (JP)	975	0.9	13.0	3.1

Source: The Banker, as quoted in OECD (2005).

Moreover, it is far from certain that NPLs have been mastered. First, there is the outstanding stock of loans that were approved up to the last batch of reforms. It is uncertain how much of this lending might turn into bad loans, depending on the SOEs reform process. Moreover, there is the issue of ongoing lending. China is currently in the middle of a credit boom, with lending growing rapidly, notably for real estate. The fundamental problems behind the past emergence of NPLs – i.e. the lack of a commercial culture and safeguards against political interference – are not in place or sufficiently consolidated to ensure that current loans are being properly allocated.[120] McKinsey estimates that the banking system can only deliver 5-7% of "safe" credit growth. However, according to McKinsey the economy requires a 15% increase in credit to deliver economic growth of 7-8%.[121]

In addition, there are NPLs in other segments of the banking industry, notably rural banks, where bad loans are estimated to amount to 23% of outstanding loans. Addressing these effectively is made difficult by a lack of resources at sub-national level, among other things. In addition, the asset management companies have had a very slow recovery rate of NPLs and it is uncertain how much of these will turn into non-performing assets. Finally, there are the remaining NPLs within SOCBs. These are difficult to address without changes to the bankruptcy proceedings or the opportunity to sell to outside investors.

Over and above the bad loans issue, there are the related challenges of insufficient capital and lack of provisioning:

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[120] A recent episode illustrates the hazards of measuring how much of ongoing lending may turn sour. In a report released in May 2006 and subsequently withdrawn, Ernst & Young, the auditing and consulting firm, tried to estimate new bad loans resulting from lending between 2002 and 2004. Their estimate – $911bn of total NPLs, $358 for the big four banks – was several times higher than the official estimates referred to above. While Ernst & Young subsequently claimed these figures as "factually erroneous", the exercise nevertheless highlights the risks associated with ongoing lending.

[121] McKinsey Global Institute (2005).

01_2006_4142_txt_EN.indd 81 12-07-2007 10:43:31

- As illustrated by the tables above, capital adequacy ratios are very low, especially as official figures are likely to overstate capital. Many emerging economies aim to have ratios in excess of 10% to cover against risk. In China, capital adequacy ratios barely reach 7%, as compared to the current minimum of 8% stipulated by the Basel agreement and Chinese law.
- Moreover, there is little provisioning against bad loans. This is compounded by a tax system that does not allow provisions to be deducted from taxable income. All in all, a significant addition of provisions is needed to cover for upcoming problems.

In sum, while the banking system does not present any immediate risk for the state's fiscal solvency, sizeable solvency problems remain. The banks therefore really must ensure that current and future lending does not lead to new bad loans. This requires more far-reaching changes.

6.1.3. Consolidating a commercial culture[122]

The banking sector needs to be diversified if not only SOEs but also private investors in general and SMEs in particular are to have adequate access to credit. This can be achieved by building on the Joint Stock Banks and the City Commercial Banks. However, the imminent dismantling of barriers to foreign entry will not be an immediate panacea, due to problems which go deeper than market access.

Overall, banks need to improve their risk management skills. A modern banking industry needs a strong credit risk management culture. Banks need to develop an ability to assess and price risk. Corporate *governance* is a first safeguard. It provides for accountability, which strengthens the ability to resist attempts at government interference in credit decisions. Financial transparency has to increase to ensure that financial positions are fully recognised. Moreover, more attention has to be devoted to compliance by regulators and supervisors.

If they are to develop SME financing, banks need to be able to price loans more freely. SMEs are associated with more risks, as they are small and often subject to more volatile earnings. To cover against these risks properly requires further interest rate liberalisation. However, irrespective of such liberalisation, the banks themselves need to develop the ability to assess these risks.

6.1.4. Foreign presence

Since China became a WTO member in December 2001, it has gradually opened up its market to foreign banks. At the end of 2005, foreign banks face geographical limitations on where they can do local currency business and face limits on the stakes they can take in Chinese banks (<25%). However, by December 2006 – five years after accession – all barriers and exemptions will be dismantled and foreign banks will have full access to China's retail and wholesale banking business.

With respect to market size, foreign investors expect huge opportunities (estimates are around 10% growth of the financial sector per annum until 2010)[123]. Foreign investors are particularly looking to larger market opportunities in corporate banking and in trade financing, following increased trading activity on the part of their home country customers. Nevertheless, foreign banks have been cautious to enter the market despite

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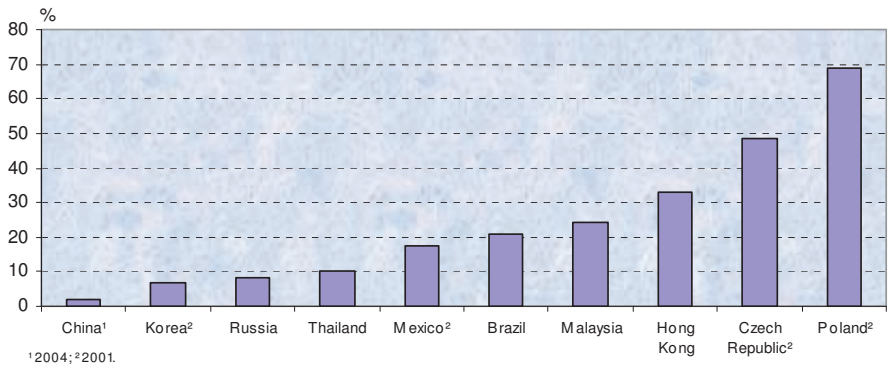
[122] This section builds heavily on OECD (2005) and IMF (2004).

[123] EC (Trade), EU Trade and Investment with China: changes, challenges and choices, 2006.

01_2006_4142_txt_EN.indd 82 12-07-2007 10:43:31

greater ease of access since 2001. For example, foreign banks' share of the loan market has not increased. Despite a handful of high-profile investments, overall foreign ownership currently amounts to only 2%. This is related to remaining investment obstacles. Establishing branches remains a difficult process for foreign banks. Consecutive branch opening is restricted to one per year. In addition, there are excessively high capital, liquidity and performance requirements for foreign firms wanting to establish branches, similar to those for an additional full bank licence. Furthermore, restrictive licensing rules remain in place for foreign firms' engagement in RMB business.[124]

Figure 6-2: Foreign banks' share of the banking market (2003)



Source: OECD (2005).

Even so, foreign banks are present, with a number of foreign banks acquiring shareholdings in China's joint stock and city commercial banks. For example, HSBC has acquired nearly one fifth of shares in Bank of Communications, China's fifth largest bank. In mid-2005 the Royal Bank of Scotland acquired nearly 10% of shares in Bank of China, China's second largest bank, while in October 2005 Deutsche Bank acquired 9.9% of shares in Hu-Xia Bank, the largest of China's joint stock banks.

The Chinese authorities are also actively coveting international capital, e.g. by allowing some banks to list on a securities exchange. Bank of China, China Construction Bank and Industrial and Commercial Bank of China, for instance, are quoted on the Hong Kong stock exchange.

[124] EC (Trade), EU Trade and Investment with China: changes, challenges and choices, 2006.

01_2006_4142_txt_EN.indd 83 12-07-2007 10:43:31

Table 6-2: Foreign investment in China's banks

Target	Acquirers	Share	Deal value (US$)	Month announced
Beijing Securities	UBS	20%	210m	Sep-05
Industrial & Commercial Bank of China	Goldman Sachs	10%	3.0bn	Aug-05
	Allianz			
	American Express			
Bank of China	Royal Bank of Scotland	10%	3.1bn	Aug-05
	Merrill Lynch			
	Li Ka-shing Foundation			
	Temasek	10%	3.6bn	
China Construction Bank	Bank of America	9%	2.5bn	Jun-05
	Temasek	5%	1.5bn	
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	19.90%	78m	Apr-05
Bank of Beijing	ING Group NV	19.90%	215m	Mar-05
Shenzhen Development Bank	Newbridge Capital Group	18%	145m	Dec-04
Bank of Communication	HSBC	19.90%	2.1bn	Aug-04
Xing Ye Bank	Hong Kong Heng Sheng Bank	15.98%	200m	Jan-04
	Singapore Government Investment Company	5%	65m	
	International Finance Corporation	4%	50m	
Shanghai Pudong Development Bank	Citigroup	5%	70m	Jan-03
Shanhai Bank	HSBC	8%	60m	Dec-01
Shanghai	Shanghai Commercial Bank (Hong Kong)	3%	20m	
	International Finance Corporation	7%	50m	
Everbright Bank	Asia Development Bank	1.90%	20m	Dec-96

Source: Lehman Brothers, CBRC and China's commercial banks as quoted in Lehman Brothers (2005).

Nevertheless, in spite of the market opportunities and WTO commitments, foreign banks may find it difficult to make sizeable inroads into domestic business, not only due to restrictions on majority shareholdings and remaining market access impediments, but also in view of the close links between domestic banks and firms, the extensive established local networks, and the rapid catching-up in banking technology by domestic firms. They may also hesitate in view of the significant residual uncertainty, notably related to legal framework, government bail-outs and corporate governance provisions.[125]

6.2. Capital markets

Capital markets play an important economic role. They offer financing to companies, thereby reducing the exposure of the banking sector to commercial risks. They facilitate company restructuring and changes of ownership and exercise an important disciplining function on company managers.[126] Capital markets could play a particularly important

[125] EC (Trade), EU Trade and Investment with China: changes, challenges and choices, 2006.

[126] Newton and Subbaraman (2002).

01_2006_4142_txt_EN.indd 84 12-07-2007 10:43:32

role in China. They would help improve corporate governance in Chinese companies, facilitate the sale of state assets and, as China is rapidly ageing, provide important high-yielding saving instruments to Chinese households.[127]

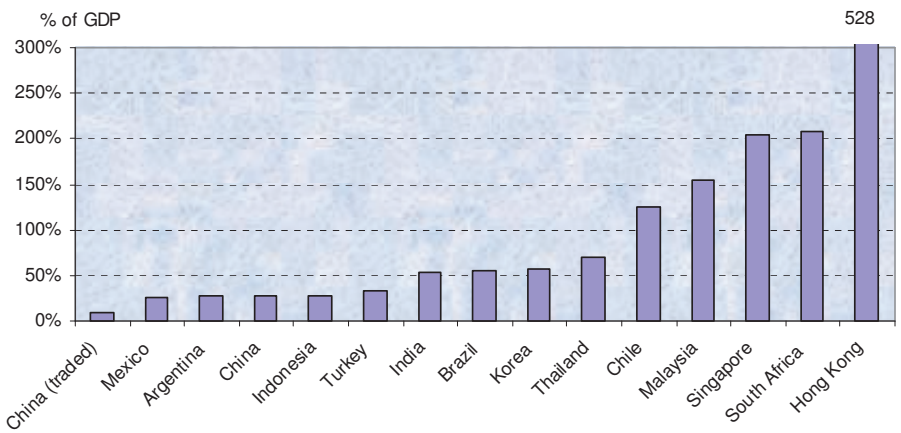
However, in spite of this central importance, China's capital markets remain limited in size, especially when compared to other emerging markets. True, from this small base they are growing fast, as evidenced by the rapid rise of China's equity markets. Even so, behind these nominal growth numbers, markets remain hampered by government imposed obstacles. Hence, their real economic size and importance remain limited. While similar problems can be found in many transition economies – with the traditional problems of weak rule of law and limited administrative capacity – they are here compounded by the fact that capital markets are not subordinated to industrial policy. The resulting mix of commercial and non-commercial logic means that they fail to function effectively, and the resulting uncertainty tends to deter foreign institutions and investors.

6.2.1. Equity markets

China has put in place the key structures underpinning modern equity markets (e.g. modern trading and post-trading systems). While equity markets at first sight appear to be fairly large in terms of nominal market capitalisation, they remain in effect small. As illustrated by graph 4.5, the domestic market capitalisation of China's equity markets – effectively the Shanghai and Shenzhen stock exchanges – amounts to 27% of GDP. Though at a similar level to Argentina and Mexico, this places it at the lower end relative to other emerging markets. However, only a fraction of this is actually traded. When the limits to tradability are taken into account, China's real market capitalisation amounts to no more than 9% of GDP.

Figure 6-3: Equity markets in emerging markets (share GDP)

Domestic market capitalisation, end 2004



Source: World Development Indicators (2005), OECD (2005) and World Federation of Exchanges (2005).

[127] OECD (2005).

01_2006_4142_txt_EN.indd 85 12-07-2007 10:43:32

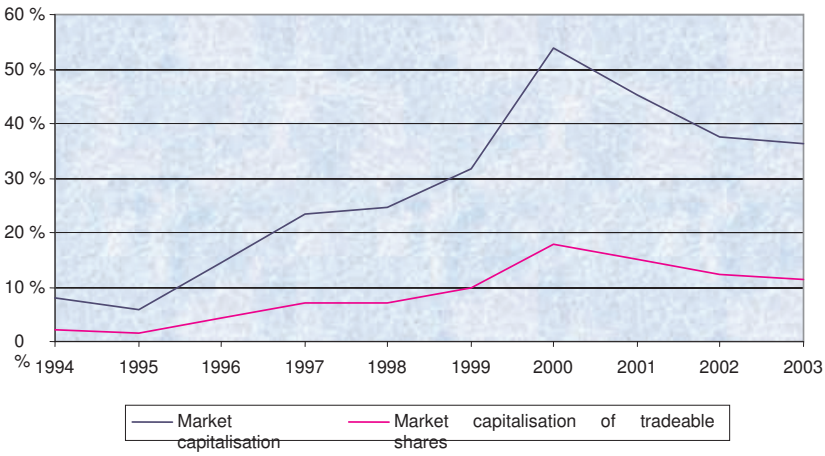
There are various reasons for this state of affairs, all related to significant government-imposed obstacles that prevent the effective functioning of the equity markets:

- ***Legacy of listings based on non-commercial criteria***. Equity markets remain hampered by the legacy of past listing policies, where listings were rationed and based on non-commercial criteria geared to supporting ailing SOEs. Accordingly, equity markets are still dominated by these large, albeit increasingly restructured, state firms.[128]

- ***Limited tradability of shares***. China has three broad categories of shares: (i) A-shares listed in mainland China, (ii) B-shares traded in mainland China in foreign currency and (iii) some listed abroad (H-shares in Hong Kong, N-shares in New York). A second category of shares are the State shares. These have only recently been subject to tradability liberalisation. The third major category is the so-called Legal Person (LP) shares, which comes in various forms. In 2002, 44% of an average listed company's shares were non-tradable.[129]

  When a SOE is restructured into a shareholding company it has to issue shares in all three categories in roughly proportionate numbers. However, only some of these shares are freely transferable and tradable. This compounds control problems, as markets cannot exercise control and sanction inefficient firms, e.g. by selling equity.[130]

Figure 6-4: Market Capitalisation and Market Capitalisation of Tradable Shares to GDP



Source: CSRC (2004).

[128] State-owned enterprises represented about 93% of all publicly quoted firms in China in 2003 (Quan & Huyghebaert 2006).

[129] Green (2003).

[130] At the end of 2003, about two thirds of total shares outstanding in publicly quoted firms remain non-tradeable, of which state shares and state-owned legal person shares represented nearly 80%. As a result, it is impossible to obtain a majority stake in most firms through purchasing their shares in the secondary market (Quan & Huygebaert, 2006).

01_2006_4142_txt_EN.indd 86 12-07-2007 10:43:33

- ***Limited ability for shareholders to exercise control***. Since the 1990s, state firms have been increasingly restructured into corporations. However, the purpose of listing a company in China as part of that restructuring process has not been to allow changes of ownership but rather to ease the capital constraint a company is under. When the current share structures were introduced in 1992, the Chinese authorities wanted to prevent local officials and company managers organising mass privatisations. Accordingly, only one third of the new share capital was publicly listed and freely tradable. The remaining two-thirds were granted to the state on the one hand and allocated to legal persons on the other (e.g. other SOEs, state holding companies and the like). Holding company stock in China therefore does not often imply shareholder control. On the contrary, control is often diluted after listing, as a listed company can raise capital that is of benefit to local industry. Accordingly, it becomes more important to the sub-national government that initially sponsored the listing. Moreover, when an SOE becomes listed, oversight is transferred from central ministries to new organisations (e.g. the securities market regulator). Making this control effective has proved to be difficult.[131] The difficulty of exercising control over company managers appears to have an impact on the financial performance of listed companies.

Table 6.3: A-share securities investment accounts composition, 2003

	Shanghai Stock Exchange	Shenzhen Stock Exchange	Total
Total accounts	35,029,000	33,322,400	68,351,800
Institutional	0.5%	0.4%	0.5%
Individual	99.5%	99.6%	99.5%

Source: CSRC (2004).

- ***Limited access to equity markets by institutional investors***. Liquidity is further hampered by the lack of demand for securities, as banks are not allowed to own or trade equity. Moreover, pension and investment funds are only allowed to hold limited amounts of equity. These restrictions are motivated by prudential concerns. However, it leads to a near total absence of institutional investors, with unfortunate consequences. First, the lack of informed professional investors renders prices less informative – and hence markets less efficient – as asset prices often deviate from the real asset value. Moreover, those institutional investors that are present are often effectively run as state bodies. China's equity markets instead rely on retail investors for liquidity. But these are wary about investing in the equity markets, as illustrated by a survey of the People's Bank of China, which found that urban households only committed 7.7% of their savings to equities in 2003.[132]

- ***Limited access by foreign investors***. Foreign investors have not been allowed access to class A-shares. However, they have access to traded shares via B- and H-shares. The former covers shares denominated in a foreign currency. The B-share class was established in 1992 and was China's first attempt to attract foreign capital. However, the market continues to lack liquidity. The H-share market is more dynamic. For example, by the end of 2003, the 93 companies – mostly SOEs – that had chosen (or been allowed) to list on the Hong Kong Stock Exchange

[131] Green (2003).

[132] Green (2003).

01_2006_4142_txt_EN.indd 87 12-07-2007 10:43:33

since 1993 had raised US$27bn. Moreover, China Construction Bank – one of the SOCBs – recently raised US$8bn from an IPO in Hong Kong.

To counter these problems, China has undertaken **a number of reforms**. First, the listing procedure has become more objective. Companies that intend to issue shares in China's domestic market must have someone sponsoring their application for an initial public quotation. The sponsor will "guide" the company and then recommends the company and submits the application documents to China's Securities Regulatory Commission (CSRC). After examination and review by the Public Offering Review Committee – composed mostly of external experts – the CSRC will make the final decision on whether to approve the application. This could make it easier for companies to gain access to equity markets. So could the restructuring of the Shenzhen exchange in mid-2004, which added a market for SMEs.[133] If successful, it would enable more companies to gain access to equity finance.

Second, the government has initiated a process of converting up to US$250bn of State shares to tradable equity.[134] This builds on prior efforts to sell off LP shareholdings to strategic private investors. This process accelerated in 2002 and led in many cases to a change of controlling shareholder. The authorities also put in place a framework for Mergers & Acquisitions to facilitate these transfers. Authorities have also put in place laws on civil proceedings against listed companies. They have also taken a tougher stance – via criminal law suits – against securities fraud and price manipulation.[135]

Moreover, the regulation and supervision function has since 1997 become centralised under the China Securities Regulatory Commission (CSRC). This is an important shift for a country where the regulatory framework was for long politicised, as local and central government officials competed to benefit most from the stock market. Until the late 1990s, regulatory institutions were under the control of sub-national governments. For example, the local securities offices that oversaw listing applications were managed by provincial leaders. Moreover, the cities of Shanghai and Shenzhen managed the stock exchanges.[136] These local leaders had an incentive to be lenient on regulation and supervision in order to spare their budgets the reconstruction costs of SOEs and collect stamp duties from the exchanges. This centralisation, in combination with attaching more weight to regulatory enforcement and compliance, appears to have improved the quality of regulation.

More recently, Chinese IPO activities have been booming, despite a short-lived dip in May-June 2006. Half of the Q2-2006 new listings on the Hong Kong Main Board have been H-shares from Chinese companies (PwC (2006)). And PwC forecasts for the rest of 2006 are even more bullish. 70 newcomers are expected, representing offerings that would raise a combined $32bn. Hong Kong remains the preferred location for Chinese companies considering an overseas listing. But the Chinese government is encouraging companies to first seek a domestic listing. In June 2006, Bank of China, one of the "big four" SOCBs, began trading on the Shanghai stock exchange after a $2.5bn domestic IPO, making it China's biggest domestic IPO.

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133 OECD (2005).

134 Shanghai Daily, 14 November 2005.

135 Green (2003).

136 Green (2003).

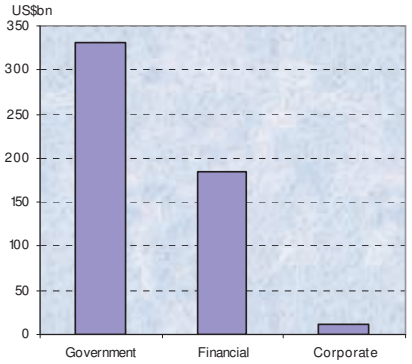
01_2006_4142_txt_EN.indd 88 12-07-2007 10:43:33

6.2.2. *Bond markets*

Well-functioning bond markets have significant benefits. They offer a market-determined term structure of interest rates, which makes it easier to accurately price credit risk. They are necessary for the launch of derivative markets, which offers a convenient way of managing financial risks. By contributing to a more diversified financial landscape they contribute to lower funding costs.[137]

Figure 6-5: Relative size of China's bond market segments

Amounts outstanding, March 2005, US$bn



Source: BIS (2005).

China's bond markets are divided into three segments: government, corporate and financial institutions bonds. Overall, China's bond markets remain small by the standards of other emerging markets, as illustrated by the graph below. By the end of 2004, the amounts outstanding on China's bond markets amounted to 34% of GDP.

Of the three segments, *government* bonds are by far the most developed. They have also been the main focus of reforms, with limited liberalisation of e.g. maturities, issue terms, issue calendar and the permission to use the repo market for short-selling. However, the market remains segmented, with trading divided between the inter-bank market and stock exchanges. It is also illiquid, with investors tending to buy in order to hold bonds.

The *corporate* segment is very small (less than 1% of GDP). This is primarily due to antique regulatory policies, notably as regards issuance.[138] Prudential concerns have led authorities to an approach aimed not so much at limiting credit risk as fully eliminating it. For example, corporate bonds need to carry an unconditional and irrevocable bank guarantee. Bond market participants have little freedom, with the government regulating the features of issued bonds (e.g. initial interest rates, maturity). Nearly all issuers are SOEs. Issues are reserved for the financially strongest companies and are moreover rationed and subject to industrial policy objectives. Additionally, domestic rating agencies remain vulnerable to influence from companies or sub-national governments.[139]

6.2.3. *Investment funds*[140]

The lack of a role for institutional investors in capital markets has been mentioned above. Establishing institutional investors now comes high on the Chinese agenda for

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137 See e.g. Newton and Subbaraman (2002).

138 OECD (2005).

139 OECD (2005).

140 This section builds heavily on OECD (2005).

01_2006_4142_txt_EN.indd 89 12-07-2007 10:43:33

transforming capital markets.[141] Institutional investors remain at a very early stage of development.

The Chinese *insurance* market is growing rapidly, at around 12% per annum. It nevertheless remains very small, as total premiums to GDP only amounts to 3.3%. This is significantly lower than the 8-12% ratio that is often found in advanced economies. Due to the former SOE-based social security system being substituted by private social security, huge future opportunities are present.

Even though a former monopoly – People's Insurance Company of China – was broken up in 1999 and some new insurers have entered the market, the offshoots of the broken-up entity dominate the life- and non-life markets. Currently about 80 institutions operate on the Chinese market. Moreover, *pension and collective investment funds* remain embryonic. This is a pity, as they are crucial if China is to cope with its forthcoming ageing boom.

China has adopted a protective regulatory regime in insurance, under which limits are placed on product and price competition. Strategically, the China Insurance Regulatory Commission (CIRC) aims to nurture the development of an insurance sector that is much stronger financially and more competitive domestically and internationally than at present.

The last years have seen some relaxation in the control of institutional investors. Insurance companies and pension funds are cautiously allowing them to invest in equities. For example, in 2004 they were under certain conditions allowed to place up to 5% of their assets directly in equities and permitted to hold up to 20% of their assets in corporate obligations.

In view of the limited domestic institutional investor landscape, foreign entry should be welcome. However, China has committed to less market opening for institutional investors as compared to banking under GATS. For example, life insurers can only enter via joint ventures and with a maximum stake of 51%. This is probably a reflection of China's unwillingness to cater for foreign entry in the absence of strong national incumbents reasonably ready to face international competition.

6.3. Informal finance

As private investors in general and SMEs and farmers in particular have problems of accessing credit via the financial system, a developed system of informal finance – i.e. operating outside the control of regulators – is in place. The size of the informal financial sector was estimated at CNY740-830bn in 2003.[142] It is particularly well-developed in the North-east – where it amounts to 30% of total finance – and the western provinces, where it amounts to over 60% of SME financing. The corresponding share for the rich coastal provinces is 30%. Informal finance is also important for providing credit to farmers.

Informal lending manifests itself in different ways and also varies between regions. It can for example be provided by individual money lenders, mutual lending networks between companies or underground financial organisations. Some of the informal lending facilities are illegal while others are more accepted and protected by the law.

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[141] OECD (2005), which quotes a seminal 2004 State Council report: "Reforming and Developing the Capital Markets in China".

[142] OECD (2005) quoting study by the Central Finance University of China.

01_2006_4142_txt_EN.indd 90 12-07-2007 10:43:34

While providing finance to companies and individuals who find it difficult to access the formal financial system, the unregulated nature of the sector presents regulators with a difficult problem, e.g. related to abuses. However, the likelihood is that as the formal financial system develops the informal sector will wane. For this to happen however, the reforms outlined above as regards bank financing and capital markets need to continue. In the meantime, the informal sector fulfils an important economic role.

6.4. Conclusion

China has made significant reforms to its financial sector. Significant resources have been invested to return the banking system to minimal levels of solvency. Reforms are also under way aimed at addressing the causes behind the banks' financial problems and the limited size of the capital markets. However, it remains to be seen whether these reforms will diminish the state's pervasive influence in the financial system, as illustrated by its past and current subordination to industrial policy objectives. It may well be that more modern financial laws, more market openness to foreign banks with comparative advantages, stronger corporate governance and more effective internal risk management systems are insufficient in the absence of the state being willing to relinquish direct ownership. Currently, that is not on the agenda.

A stronger financial system is critical for China. The importance for growth was highlighted in the introduction. In addition, China will find it more costly to become more integrated in the world economy without a sound financial system. For example, China has long been wary about liberalising external capital flows due to the weaknesses reviewed above. As it becomes increasingly integrated into the world economy, capital controls come with increasing costs, e.g. as regards the ability to run an independent monetary policy. Therefore, addressing the problems identified above is important. While China has come a long way, much remains to be done.

01_2006_4142_txt_EN.indd 91 12-07-2007 10:43:34

7. REFORMING THE PRODUCTION SYSTEM[143]

While Chinese structural reforms of the financial sector have received most of the attention, reforms affecting the production system, both public and private, have been equally challenging and complementary to financial sector reforms.

7.1. Reforming China's public sector

The number of state-controlled companies (state-owned enterprises and companies controlled by the state) in China has fallen remarkably over the past decade, as documented in chapter 1. In 2005 they accounted for 12% of the total number of firms, versus 60% domestic private enterprises.[144] Furthermore, there has been considerable restructuring even in the firms that have remained under state control. Employment in state-controlled industrial companies fell by almost 40% between 1998 and 2003, as 16 million workers were laid off. The size distribution of state-controlled firms in terms of employment after this massive shake-up has remained virtually unchanged, suggesting that state divestment was across-the-board.

Many state firms have reorganised into limited liability companies (LLCs) and shareholding corporations, often with outside shareholders. Collective enterprises controlled by local governments have restructured and exited even more rapidly than state-held firms.

Reforms were introduced to improve internal incentives in those firms that remained in state hands. Since 1999, corporate governance reform of SOEs has become a priority in China. One component of the strategy is the conversion ("corporatisation") of SOEs into legally independent joint-stock companies and the establishment of boards of directors and supervisors together with laws defining their responsibilities and those of managers. With this, the authorities have sought to curtail direct government intervention in enterprise management by creating separate organs to manage state-owned assets. The second component, which has been given increasing emphasis, is to list corporatised SOEs and diversify their ownership in a bid to impose further discipline on the boards and managers. By the end of 2003, more than 1000 state-owned enterprises of middle and large size have been privatised, through listing some (mostly only a minority) of their shares on the two national exchanges, Shanghai and Shenzhen, or on the Hong Kong stock exchange.

The tangible results of the governance reforms have fallen short of expectations, however. Most studies (e.g. Wei et al 2005) claim that the selection of SOEs for listing is rarely based on economic merit, attractiveness to investors or the need of capital, but is highly politicised. This may help explain why SIPs (share issue privatisation) in China have so far been of only limited success. Many studies indeed show that the financial and operating performance of SOEs in China even deteriorates after their SIP.[145] Actual corporate governance practices continue to deviate considerably from international standards. The boards of directors and supervisors mandated by corporatisation do not yet have sufficiently distinct identities within the enterprise, and their independence is

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143 Based on OECD (2005).

144 Lehman Brothers (2005). Nevertheless, these 12% of firms represent 37% of sales and 50% of liabilities, indicating that these SOEs are above average size and overrepresented in liability problems.

145 e.g. Sun & Tong, 2003, Quan & Huyghebaert 2004

01_2006_4142_txt_EN.indd 92 12-07-2007 10:43:34

limited. Top managers continue to be appointed by local authorities or political officials. The boards tend to function more as an extension of management than as its monitor, and are effectively bypassed in exercising genuine oversight. The autonomy of managers is weakened by their dependence on government or political authorities for their position, their low salaries, and their lack of a direct stake in the firm's profit performance.

Following the limited success of earlier reforms in improving state-held enterprises' performance or reducing outstanding debt, the State Assets Supervision and Administration Commission (SASAC) was created in 2003 as a new agency to address the problems of the state sector. SASAC is entrusted by the state with capital provider responsibilities. SASAC has begun to clarify the strategic core sectors in which it will concentrate its state holdings. One promising initiative that SASAC has taken is to foster a more open property rights trading system: three major trading centres have been created nationally to facilitate the auction, sale, and transfer of state company shares and assets.

Box 7-1: China's industrial policy

Since the start of its economic reforms in the late 1970s, China has persistently pursued targeted industrial policies. Industrial policy objectives are embedded in the country's FDI, Science & Technology, Education, Taxation policies. In particular, the promotion of large-scale enterprises remains an important part of central government policy ("national champions"). China regards the establishment of large conglomerates as the best way for domestic enterprises to achieve economies of scale and compete with international firms both domestically and in international markets. Company groups have been identified in the **energy, defence, ferrous and non-ferrous metals, motor vehicles, chemicals, transport, aerospace, pharmaceuticals and electronics sectors**. The government considers these areas to be of "strategic" importance to the national economy.[146] These "national champions" were given special treatment, such as 'easy loans' from state-owned banks and other preferential treatment. The government encourages these companies to consolidate: many of the M&As that have taken place in recent years have been government managed. [147] At the same time, enterprises are required to focus on no more than about three main industries. Through this process of consolidation SASAC aims to improve the efficiency of investment and strengthen core competencies.

Following these improvements, rates of return have not improved evenly across all state-controlled companies, even though the reform effort has been fairly widespread across industries. Looking at the economy as a whole, the performance of state companies outside the industrial sector is well below that in industry. Within industry, the biggest improvements have come from the upper end of the size scale. Changes in the middle of the distribution have been quite modest. The long tail of the distribution of performance means that a significant group of state firms remain insolvent despite improvements in the aggregate state sector indicators.

Accordingly, despite the reforms there remain a large number of state enterprises in the industrial sector that compare poorly with private companies in terms of productivity. This large tail of badly performing public enterprises continues to drain financial resources from the economy. Increasingly severe budget constraints in the context of deteriorating financial performance were a strong incentive for restructuring and

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[146] Note that these sectors are also of importance for the EU's competitiveness, see part III of the report.

[147] For example, under its 10th 5-year plan for the auto industry (2000-2005), the government encouraged 100 small automobile manufacturers to merge with the three giants: First Automotive Works, Dongfeng Automobile and Shanghai Automobile Group

01_2006_4142_txt_EN.indd 93 12-07-2007 10:43:35

privatisation, but have been held back by several factors: excess employment, outstanding debt, and ideological pressures.[148]

Further reforms are therefore needed. Now that the core industries in which the state plans to retain control have been decided, a rundown of state-control can and should be pursued in the remaining industries. In order to improve performance among the substantial number of enterprises with financial difficulties, it is important to enhance the market for corporate control. As international evidence on state enterprise restructuring suggests, transfer of control is the key to improving ownership, with outside owners being most effective.[149] As in other countries, stronger market discipline is critical in establishing a firm and lasting foundation for effective corporate governance.

Foreign participation in the form of cross-border mergers and acquisitions of Chinese companies is also a useful option to facilitate restructuring. Foreign firms are interested in acquiring domestic enterprises to gain a strategic position in the domestic market: access to distribution channels, customers and resources embedded in domestic companies with potential. In return, they bring in the necessary capital, and technological and managerial know-how. Nevertheless, barriers persist for M&As involving foreign firms (*cf infra*).

However, not all state companies are suitable for sale or outside stakeholding. Non-viable companies need to exit the market and sell their assets. While concern about potential unemployment from bankruptcy is understandable, an even greater reliance on market bankruptcy in the short term is advisable with a view to reducing risks to the banking system and improving the competitive environment.

7.2. Reforming China's private sector

Despite the various improvements in the regulatory environment over recent years, significant problems remain for private entrepreneurs. These include a lack of access to finance (see chapter 6), and impediments through a malfunctioning labour market (see chapter 10), difficulties in entry, competition and exit, and a range of barriers to operation and expansion.

7.2.1. Financial constraints

Surveys of domestic private businesses consistently report financial constraints as a major impediment to business. China is one of the developing countries most dependent on retained earnings for financing investments.

Table 7-1: The importance of financing constraints for Chinese enterprises and the consequent importance of retained earnings as a source of finance

	Financing constraints (1=no, 4=major obstacle)	Sources of financing of fixed asset investment (%)		
		Retained Earnings /	Equity/	Commercial Banks
China	3.35	57.8%	2.62%	9.3%
East Asia	2.45	35.5%	3.6%	15.2%
India	2.55	27.1%	5.2%	22.0%

Source: Y. Huang, MIT (2005) on the basis of WBES

[148] Guo and Yao (2004)

[149] OECD (2005)

01_2006_4142_txt_EN.indd 94 12-07-2007 10:43:35

The reform of the financial sector as discussed in the previous section is therefore of paramount importance for the continued growth of the business sector, which needs access to capital for financing investments to enable it to grow to the point where it can compete on global markets.

7.2.2. Barriers to entry

Despite the large number of new firms emerging from the large reservoir of Chinese entrepreneurial capacity, business entry is a major problem for private entrepreneurs in China. Problems include long delays, lack of transparency in decisions, favouritism by local governments, and pressure to pay unauthorised fees. Long delays in registering a company had been typical until 1999. Since then improvements have been made. In the following five years, estimated registration times (on a comparable basis) dropped from over 100 days to 41 days.[150] Entry nonetheless is limited by the high level of requisite start-up capital. In China, the minimum capital to start a company is eleven times the average income in 2003. Limiting arbitrary intervention on the part of local authorities is one of the most important aspects of the new administrative licensing law. Authorities are now required to grant a licence unless one of a specified list of valid reasons can be cited (health, safety, environment, national security, and "other" laws and regulations). This law, if properly implemented, could serve to ease entry barriers.

7.2.3. Barriers to exit

Current bankruptcy procedures have a number of drawbacks that prevent the efficient reallocation of resources. Barriers to exit, by maintaining inefficient firms in the market, act as an impediment to entry and growth for efficient firms. In addition, the bankruptcy law does not give adequate protection to creditors, which will prevent them from providing funding in the first place. Given that creditors have difficulty enforcing their rights under current legislation, they are reluctant to use bankruptcy proceedings, keeping inefficient firms alive too long. A new bankruptcy law that will potentially make Chinese law compatible with international best-practice is currently being drafted. The acid test, though, will be how it is implemented. At present, there is little experience in implementing bankruptcy in a market-based fashion.

7.2.4. Legal barriers to operation and expansion

There is no uniform company law governing all enterprises. A number of enterprise structures co-exist with governing corporations, state-owned enterprises, solely state-owned corporations, collectives, co-operatives, foreign enterprises and joint ventures. The basic company law dates from 1994 and was focused on setting a new framework for the state and private sectors. However, the law sets high minimum capital requirements on the formation of limited liability and stockholding companies, and does not allow single-owner firms to be incorporated. Further revisions of Chinese company law are needed to reduce these limits and to increase transparency and accountability.[151]

As already indicated for state-owned firms, stronger market discipline is critical in establishing a firm and lasting foundation for effective corporate governance. Greater use of qualified independent directors, including outside directors, should be part of an

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[150] World Bank and IFC (2004)

[151] These issues are an important component in the discussion on China's non-market status in anti-dumping legislation.

01_2006_4142_txt_EN.indd 95 12-07-2007 10:43:35

effort to *strengthen the independence and powers of boards of directors and to foster greater accountability and professionalism among managers*. These steps would help to lay the foundation for a market for managers, which is now lacking, and for the more widespread adoption of performance-based reward.

7.2.5. Barriers to trade

Based on China's commitments under the WTO, numerous laws and regulations that were deemed inconsistent with free trade have been amended or abolished.

Barriers to **inter-regional competition and trade** have led to market fragmentation **within China**, making it impossible to fully exploit the huge Chinese internal market. The remaining barriers to intra-regional trade (as seen by entrepreneurs) reflect more a local bias in the legal system, local protectionism and barriers in the labour market, rather than price and quantity barriers. With the move towards fiscal decentralisation (*cf infra*), local governments have had a strong incentive to shield local firms and protect their tax base.

The central government has been trying to do away with regional protectionism. But provinces too have been joining forces to create trading blocs, such as the Pan Pearl River Delta regional trading bloc, the Pearl River Delta region and the Yangtze River Delta. Data on inter-province trade, observation of regional price differences, the impact of shocks on the price level and regional specialisation, all point to an increasing market integration within China, supported by investments in transport infrastructure.

International openness is helping to improve the functioning of domestic markets as well. The Foreign Trade Law adopted in 2004 enables all firms – private ones included – to directly engage in importing and exporting. This early fulfilment of a WTO commitment enables firms to trade internationally without going through Foreign Trading Companies, giving them much easier access to global markets and reduced transaction costs. Exporting firms that have to compete on international markets are typically more productive. Also the competition induced by FDI can improve the functioning of domestic markets. Although China has seen and stimulated massive inflows of FDI, these flows and their impact on the local economy have been strongly influenced by government policy choices rather than market mechanisms (*cf supra*).

In response to the rapid emergence of FDI-related M&As, the government set up an M&A notification system in March 2003. The purpose is to promote and regulate FDI, to derive maximum benefit from the transfer of technological and managerial know-how, to secure employment and to safeguard competition and national security. The provisions require foreign investors to notify MOFCOM and SASAC if size and/or market share thresholds are met.

7.2.6. Barriers to competition

China did not have a **competition policy** until the reform process started in the late 1970s. Currently the main competition laws and regulations are the 1980 Provisional Regulations Concerning Development and Protection of the Socialist Competition Mechanism, the 1993 Anti Unfair Competition Laws and the 1998 Price Law (see Box). China began drafting a comprehensive anti-monopoly law in the early 1990s, but his has not yet reached the statute books.

01_2006_4142_txt_EN.indd 96 12-07-2007 10:43:35

Box 7-2: China's competition law

The 1993 Anti Unfair Competition Law was China's first competition law. Its goals were to protect competition and prevent unfair trade practices. The Unfair Competition Law (1993) deals primarily with a number of practices that are best described as unfair trade practices (e.g. trademark counterfeiting, bribery, misleading advertising, and trade secrets). Some anti-competitive practices (predatory pricing, tie-in sales, bid rigging, etc) are banned by law. The 1993 Anti Unfair Competition Law provides for criminal penalties only in the cases of trademark infringement and bribery. SAIC, with its Fair Trade Bureau, is the administrative body responsible for enforcing the law. It has branches throughout the country. It can take corrective measures, including imposing fines. While the enforcement record of SAIC is impressive (Lin 2005), most of the cases it has dealt with have involved administrative measures. Only a tiny percentage of cases have been turned over to the judicial system. This indicates the heavy reliance of competition enforcement on administrative channels.

The 1998 Price Law complemented the Anti Unfair Competition Law. Its main objective is to fight price fixing and predatory pricing. It specifically outlaws price cartels.

China's existing competition laws focus primarily on unfair competition. They do not deal with monopolisation, abuse of dominant position or M&As. The new anti-monopoly law is currently being drafted in international consultation, including the European Commission's competition service. A distinct feature of the draft is that it deals explicitly with administrative monopolies.

The delay in enacting this legislation (drafting of which started in 1994) is in part due to a misplaced feeling that current low levels of concentration preclude anti-competitive practices and concerns that a competition law could complicate mergers needed for consolidation.

Using the National Bureau of Statistics (NBS) industrial micro data to compute the concentration ratios, the OECD (2005) showed that overall concentration in the industrial sector is indeed not very high by international standards.[152] In many markets, consolidation could well produce important efficiencies without creating a competition problem. The reason is that many Chinese firms are undersized as a result of past laws and policies. The lack of a mid-tier market segment is a particularly serious weakness. While entry has been substantial, the newly established firms have found it difficult to grow. This is due to the barriers to growth identified above, more particularly lack of finance and poor corporate governance. Although China has fifteen *Fortune 500* companies (in 2005), most of these firms are large SOEs, especially in resource and monopolistic sectors. So large firms are mostly a policy story, not a growth story.

Most private companies are (too) small. Out of 3.4 million private firms, only 1 130 have more than 1 000 employees, and the average firm employment in 2003 was 14 persons,[153] According to estimates based on the NBS micro database, higher concentration in many Chinese industries would actually enhance the productivity of incumbent firms. These gains could be obtained through efficiency-enhancing mergers that facilitate economies of scale.[154]

The merger control provisions in a well-designed anti-monopoly law do not prevent efficient mergers, but only preclude the relatively few mergers whose efficiency benefits are likely to be outweighed by anti-competitive effects. At the same time, eliminating

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[152] 83 out of the 587 industries are highly concentrated (an HHI of over 1800 points), while 425 industries are not concentrated (HHI<1000).

[153] Y. Huang (2005)

[154] OECD (2005)

01_2006_4142_txt_EN.indd 97 12-07-2007 10:43:36

some of China's current restrictions on mergers and acquisitions (M&A) would be beneficial for this scaling-up. Currently takeovers require the consent of the target company and its workforce, as well as of multiple government departments.

Another factor holding back the effort to set up a comprehensive competition law is a possible conflict of interest with the pursuit of industrial policy. A serious problem for competition is the extent of remaining state ownership, especially in the sectors selected as "strategic" (*cf supra*). The introduction of an anti-monopoly law could work against the government's policy of encouraging the formation and development of large enterprise groups in these sectors. This view however again incorrectly equates competition policy (in casu anti-trust) with a bias against bigness.

With a general anti-monopoly law hopefully to be in place soon, China will have a fairly complete set of competition laws. Law enforcement will then be the biggest challenge facing the country. It will be interesting to see how the government balances fair competition on the one hand against protection of domestic enterprises on the other. Therefore it is important that China sets up a powerful and independent competition authority.

One area which is lagging behind in reforms is public procurement policies. Since its WTO membership in 2001, China has not yet signed up to the Government Procurement Agreement. Current rules discriminate particularly against foreign-controlled companies located in China.

7.3. Conclusion

State-owned enterprises continue to be the main source of non-performing loans. These enterprises therefore need to further restructure their ownership and governance. Stronger market discipline is critical in establishing a firm and lasting foundation for effective corporate governance. While concerns about potential unemployment are understandable, a greater reliance on market bankruptcy for non-viable companies is nevertheless necessary to reduce risks to the banking system and to improve the competitive environment.

Despite the vibrant entrepreneurial spirit of the Chinese population, the development of the private sector remains hampered by substantial barriers to entry, exit and competition. China's "national champions" policy in "strategic sectors" comes at a cost: an underdeveloped competitive system. A new set of competition policy laws should improve the functioning of product markets. A major challenge will be to deal with potential conflicts between industrial policy, FDI policy and competition policy, requiring a sufficiently independent competition authority.

01_2006_4142_txt_EN.indd 98 12-07-2007 10:43:36

8. REFOCUS PUBLIC FINANCES

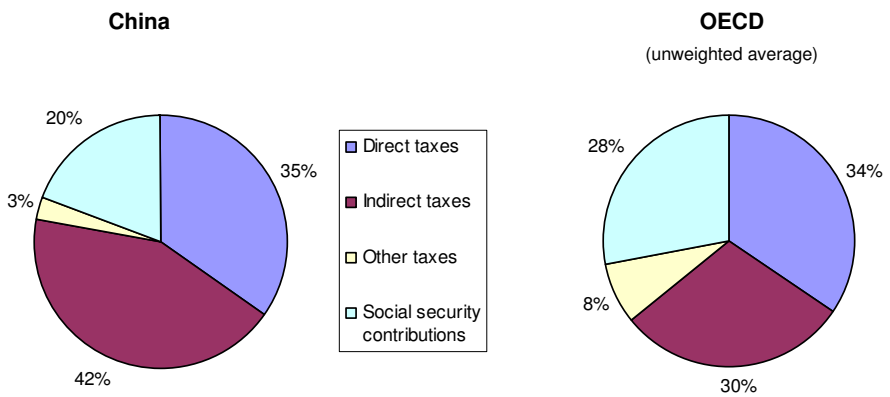
The purpose of this section is to review the structure of China's public finances and assess to what extent they currently address the challenges China is facing or could be mobilised to address the challenges China will face in the near future. China's public finances have gone through significant changes during the last decade. The current system was put in place in 1994 with the aims of (i) simplifying the tax system, (ii) raising more revenue, (iii) increasing the central government's share of the revenue and (iv) making the system more stable by replacing ad hoc negotiations with pre-set rules.[155] Public finances have since grown faster than the economy, but remain low by international standards. They are by and large in a healthy state, with the budget deficit and national debt in 2004 standing at around 1% and 23.5% of GDP respectively.[156] However, (i) expenditure is not sufficiently focused on China's upcoming challenges, (ii) revenue is often raised in a distortive and opaque manner and (iii) poorer regions and counties have difficulties in financing their expenditure obligations.

8.1. Raising revenue

Until the early 1990s, fiscal revenues decreased, especially those accruing to the centre. Since the 1994 reform, revenues have expanded 13% per year. The rapid growth is explained by (i) a rapidly growing economy and (ii) changed incentives as part of the reform that has put more revenue on the books, (iii) a centralised tax administration that has proved to be a more effective tax collector.

In terms of structure, China relies more on indirect taxes (VAT) compared to most OECD members.

Figure 8-1: Structure of selected government revenues (2003)



Source: OECD (2005).

[155] Ahmad et al (2002).

[156] OECD (2005).

01_2006_4142_txt_EN.indd 99 12-07-2007 10:43:36

While there are a number of problems with the current way of raising tax (e.g. distortions, limited local freedom) thanks to rapid growth, these problems have not had a material impact on revenues. So far China has managed to raise more and more revenue thanks to its growth performance without having to adjust the tax rates or bases or by adding new taxes. However, in view of future demands on additional expenditure (see below), this may become necessary in the years to come.

8.2. Allocating revenue

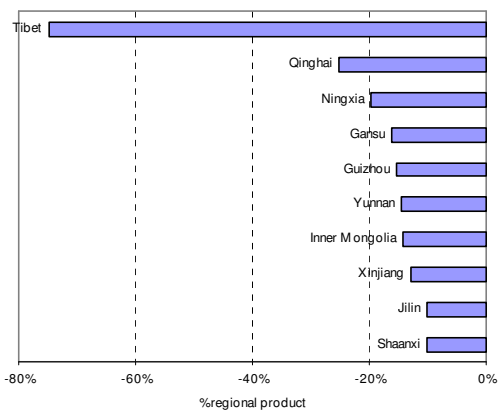
The revenue raised is subsequently allocated between the central and local governments. The 1994 reform also put in place a new system for allocating tax revenues and transferring some of the revenue allocated to the centre back to local governments.

The ownership of various tax revenues is clearly allocated, with some taxes belonging exclusively to one layer of government and others being shared. For example, while the central government has full ownership of excises, customs duties, and VAT and excises on imports, local governments have full ownership of personal income taxes. Domestic VAT, by far the most important tax revenue, is shared, with 75% going to the centre.

However, the reformed fiscal system has not been effective in dealing with the large regional income disparities that have arisen in China over the last decades. On the contrary, there are signs that the system has accentuated these disparities. The main reason relates to the allocation of tax bases. Rich regions raise more tax. As the value added is higher in most cases for secondary and tertiary sectors as compared to primary, regions rich in the former raise more tax. These happen to be the coastal regions, while agriculture is centred in the central and western regions. As the coastal regions are richer, and wage remuneration more common, these regions also raise more personal income taxes. Therefore, tax yields are actually more unequally distributed than the already unequally distributed income.[157]

Figure 8-2 Selected regional government budget deficits

(2003, % of regional GDP)



Moreover, compared to previous systems – where local governments had more scope to retain revenue from the centre – local governments have lost that discretion since 1994. Local governments have also faced increased pressure on expenditure, as (i) social responsibilities formerly put on SOEs have been transferred to local governments as part of the industrial sectors restructuring, (ii) urbanisation has forced many regions to invest more in basic services (e.g. sewerage), (iii) the population is ageing, and pension payments remain the responsibility of local governments, and (iv) minimum service standards have become set by the centre. Accordingly, while local governments are responsible for around 70% of total government expenditure, their direct revenues amount to only 45%. As local

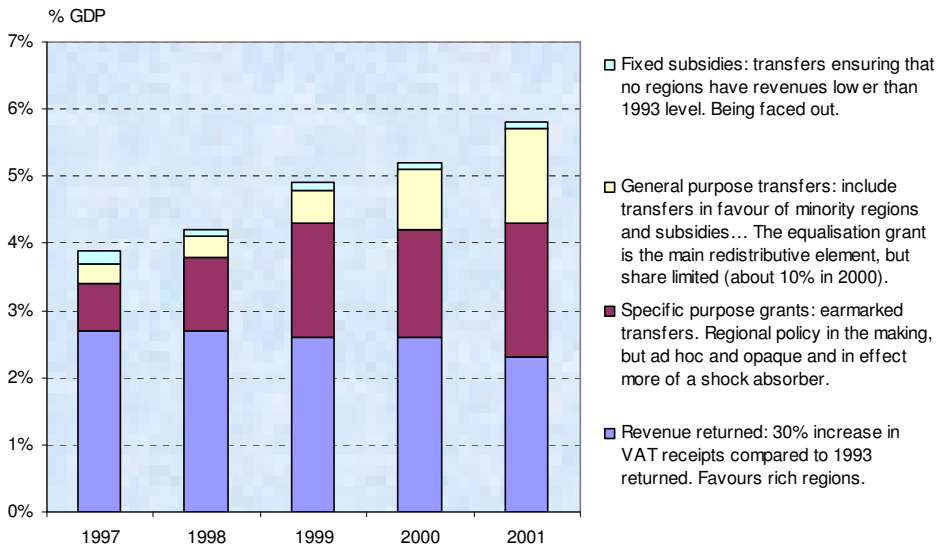
[157] OECD (2005).

01_2006_4142_txt_EN.indd 100 12-07-2007 10:43:37

governments only have very limited ability to set the tax base or the tax rate, this has put serious strain on many local governments' budgets.

In order to assist local governments, the 1994 reform significantly increased transfers from the central to local governments. As a result, much of the revenue allocated to the centre is immediately transferred back to local governments.

The 1994 Transfer System


% GDP
7%
6%
5%
4%
3%
2%
1%
0%
1997
1998
1999
2000
2001
Fixed subsidies: transfers ensuring that no regions have revenues lower than 1993 level. Being faced out.
General purpose transfers: include transfers in favour of minority regions and subsidies… The equalisation grant is the main redistributive element, but share limited (about 10% in 2000).
Specific purpose grants: earmarked transfers. Regional policy in the making, but ad hoc and opaque and in effect more of a shock absorber.
Revenue returned: 30% increase in VAT receipts compared to 1993 returned. Favours rich regions.

Source: data from IMF (2004).

Despite their significant size (5.8% of GDP in 2001, up from 1.5% in 1993), transfers have so far proven insufficient in addressing inequalities in revenue-raising power and outcomes between regions. The reason is that the major part of the transfers – revenue returned – favours richer regions that raise more revenue in the first place. Moreover, the redistributive parts of the transfers – the equalisation grant – remain limited.[158]

Nevertheless, the transfers manage to somewhat reduce the inequality of tax yields between regions, thereby ensuring that regional expenditure is less diverse.[159] Nevertheless, local government spending remains largely linked to local revenues. The provision of public services therefore varies considerably between regions and ultimately depends on the level of regional economic development.[160] The further down one goes in the administrative system, the more pronounced these differences become; sub-regional governments are more dependent on transfers than the regions are.

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[158] This is no accident, but part of the negotiations leading up to the 1994 reform. In order to secure agreement, the equalisation objectives of the transfer system were limited. See, Ahmad et al (2002) for further details.

[159] OECD (2005).

[160] Ahmad et al (2004).

01_2006_4142_txt_EN.indd 101 12-07-2007 10:43:37

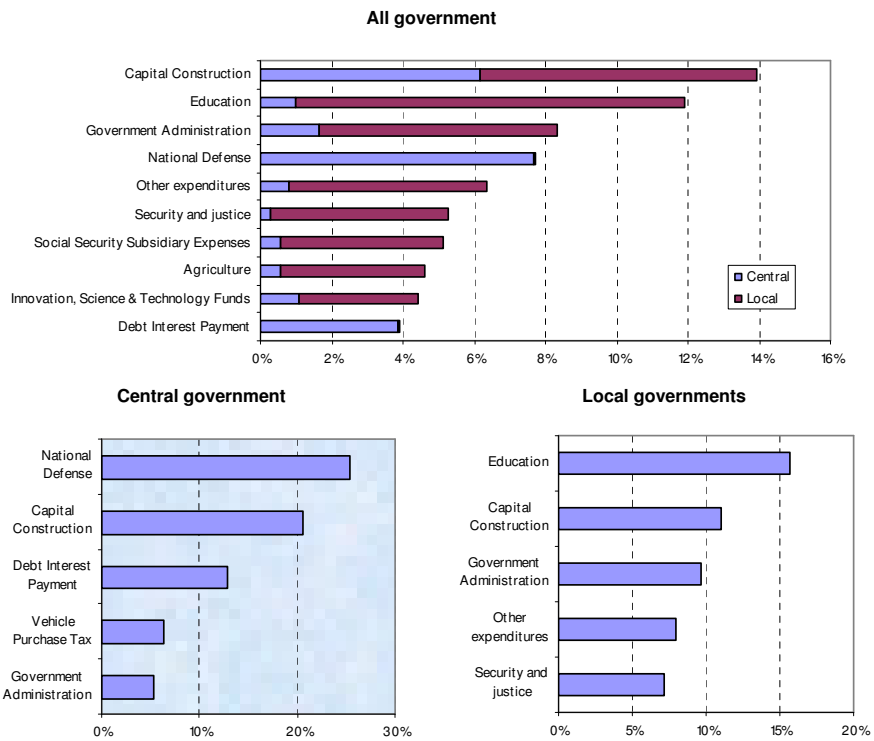
Local governments have therefore had increasing difficulties in meeting their expenditure obligations, even post-transfers. Some have experienced payment arrears. Most have resorted to raising additional income from fees and charges. While sub-national governments are forbidden to borrow directly, some have nevertheless done so illicitly. Others have shifted investment off the budget balance sheet to non-government entities, which then borrow money either via banks or bond markets. These practices contribute to opaqueness and may be risky, as the government at the end of the day is quite likely to carry responsibility for any liabilities.

8.3. Spending

Since 1994, government expenditure has increased faster than revenue (though the increase has been slower since 2000). Expenditure as a share of GDP nevertheless remains low by international standards: at 26%, it is 14 percentage points below the OECD weighted average.[161]

Figure 8-3: Top expenditure items

(Share total, 2003)



Source: National Bureau of Statistics of China (2005).

The government has over recent years aimed at focusing expenditures on human capital by gradually increasing spending on pensions, social security and education. Even so, as illustrated by the graphs above, a very large part of the cumulative spending of all layers

[161] OECD (2005). If interest payments and social security disbursements are excluded, China's 24% is only one percentage point below the OECD weighted average.

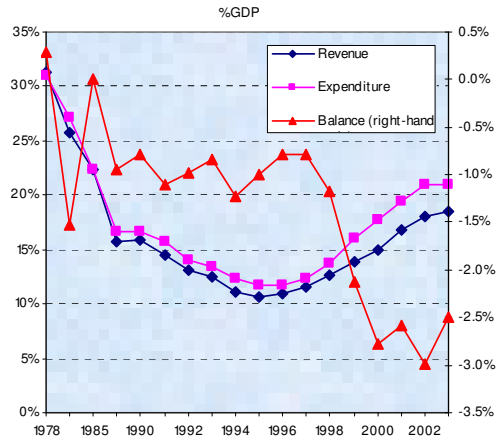
01_2006_4142_txt_EN.indd 102 12-07-2007 10:43:37

of government remains focused on physical capital (nearly 14% of total expenditure in 2003).

8.4. Budget balance

As overall expenditure has increased faster than revenue, the fiscal position deteriorated until 2002. Since 2002, despite continued increases in revenues, China has managed to reduce its deficits somewhat. Accordingly, the stock of national debt reached 25% in 2002, before declining to 23.5% of GDP in 2004. The deficits are primarily financed domestically, as the share of foreign debt was only 4% of GDP. Thanks to buoyant growth and low interest rates, the deficits are nevertheless manageable. Interest payments in 2002 only amounted to 2.6% of revenue (0.6% of GDP).[162]

Figure 8-4: China's public finances



Source: National Bureau of Statistics of China (2005).

Even so, China's public finances are facing strains in the near future and the current structure of expenditure and negative, albeit moderate, balances restrict China's margin of manoeuvre. One source of problems relates to a number of direct and contingent liabilities that China is facing. For example, as explained elsewhere, the banking sector is riddled with non-performing loans. Significant capital injections have already been made, but new bad loans are likely to materialise. Accordingly, it has been estimated that it would cost up to 30% of GDP to fully resolve the bad loans crisis. The restructuring of SOEs, as reviewed above, is also a costly process. Moreover, the indirect financing resorted to by sub-national governments referred to above may also require further budgetary resources, estimated at 3-10% of GDP.[163]

8.5. Refocusing expenditure to address social challenges and provide a better foundation for growth

China is facing a number of social challenges in the short- to medium-term future. In the wake of economic reforms, individuals have had to carry more of the financing burden of acquiring education and insuring themselves against social risks. Households accordingly save a high proportion of their disposable income. However, large parts of society are increasingly excluded from adequate social insurance and education. To reduce potential tensions arising from the inequality of access and to moderate the macro-economic imbalances resulting from the high level of savings, public finances may have to take on a larger share of the responsibility.

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[162] OECD (2005).

[163] OECD (2005).

01_2006_4142_txt_EN.indd 103 12-07-2007 10:43:38

8.5.1. Social insurance

Before the economic reforms were initiated in the late 1970s, companies provided basic insurance against social risks to their employees. As part of the economic reforms, companies typically no longer provide these insurances. So far, the state has not fully taken on the responsibility, although China has had a comprehensive system for social insurance – covering pensions, health, unemployment, injury and maternity leave – in place since 1997. Accordingly, the coverage of social insurance – notably in the area of health – is no longer as comprehensive as it used to be. The costs for the individual have increased, though, as the new system relies on high private contributions (41% of the total wage bill).

Table 8-1: Social security contribution rates

(% of wage, 2005)

	Pension	Health	Unemployment	Injury	Maternity	Total
Enterprise	20	6	2	1	1	30
Individual	8	2	1			11
Total	28	8	3	1	1	41

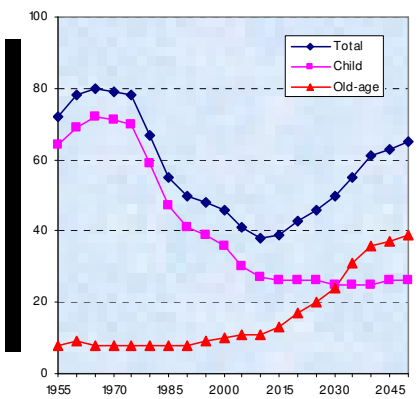
Source: OECD (2005).

The emerging system remains segmented between rural and urban areas. Moreover, the coverage varies widely between regions, but also between types of enterprise. The new system also remains poorly administered, with e.g. a large share of private firms not participating in the scheme despite its compulsory nature. The remainder of this section reviews recent developments and remaining challenges in the two largest parts of the social insurance system: pensions and health.

- **Pensions**. The pension system is currently changing. Since the reforms started, it has moved from a pay-as-you-go (PAYG) system, via a hybrid system combining defined benefits and contributions, into today's three-tier system.

  The first two tiers of the new system are mandatory. The first gives the right to a flat-rate pension equal to 20% of average local wages in a given locality, provided that the pensioner has contributed for at least 15 years. The second tier provides notional individual accounts. This gives the pensioner the right to a monthly annuity based on past contributions and accumulated interest. Only those companies that comply with these first two tiers have the right to provide third-tier funds. However, these are too costly for many state-owned firms to provide and, accordingly, coverage remains very limited (7 million people in 2003).

  Figure 8-5: Dependency ratio

  Source: United Nations (2005).

  The transition to this system has not been without problems. The cost issue has not yet been solved. For example, imbalances in pension systems run at sub-national level cannot be counterbalanced by transfers between regions. Instead, the central

01_2006_4142_txt_EN.indd 104 12-07-2007 10:43:38

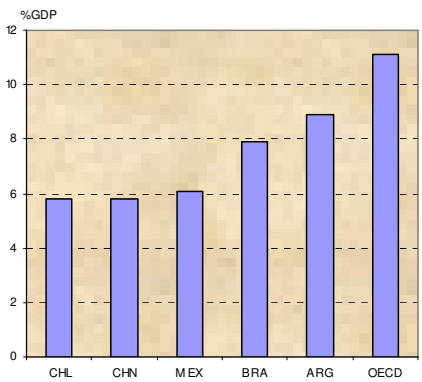
government is responsible for financing deficit regions, while surplus regions can either lower contribution rates or invest potential surpluses. Moreover, coverage remains low. In 2000, participation was restricted to 14% of total employment and registered unemployment. Private firms and foreign firms remain reluctant to participate. In addition, due to variations depending on enterprise type, portability between firms and regions is limited. The resulting segmentation is another barrier to the development of a national labour market.

As China over the next decades will experience the fastest rate of ageing among developing countries, a sounder pension system needs to be put in place sooner rather than later. The reasons behind China's rapid transformation are an increase in longevity coupled with the one-child policy that has been in place since the 1970s, which exacerbated the decline in fertility rates. As a result, the growth rate of the workforce will soon experience a sharp slowdown.[164] Overall, from 2015 onwards, the size of the working population compared to the old and young (dependency ratio) will decrease, as will the overall size of the population (see graph). Accordingly, as there will be fewer people working relative to pensioners, the PAYG elements of the current system will be more difficult to sustain. The funded parts of the system (tiers 2 and 3) therefore need to become more important. Were these funds to be allowed to invest in Chinese companies, it would have the added benefit of providing an important boost to the development of China's capital markets.

- **Health**. China's economic transformation has been accompanied by a switch from a publicly provided system to something more like a market-based one. However, there are signs that this has significantly decreased access to health care, making it the privilege of those with the means to afford it.[165]

Figure 8-6: Health expenditure

(2002, total, % of GDP)



Source: World Bank (2005).

While China's overall expenditure on health – 5.3% of GDP in 2002 – is in line with some OECD members, the public share of expenditure has decreased substantially since the beginning of reforms. In 1994, public spending on health amounted to 4.2% of on-budget spending. In 2002, the corresponding figure was 2.9%, or 0.6% of GDP. Instead, individuals have come to carry a much larger share of the cost of medical care. For example, in 1980 the share of out-of-pocket expense in medical care amounted to 16%. In 2001, the corresponding figure was 61%.[166]

As a result of the decrease in public spending on health, the coverage of health insurance has declined substantially. In 2003 only half of the urban population and

[164] Qiao (2006).

[165] Donald and Benewick (2005).

[166] Kanbur and Zhang (2003).

01_2006_4142_txt_EN.indd 105 12-07-2007 10:43:38

one fifth of the rural population were covered. Moreover, health "inputs" in terms of personnel and hospital beds have decreased substantially. For example, between 2001 and 2002 the number of doctors decreased from 2.1m to 1.8m.[167]

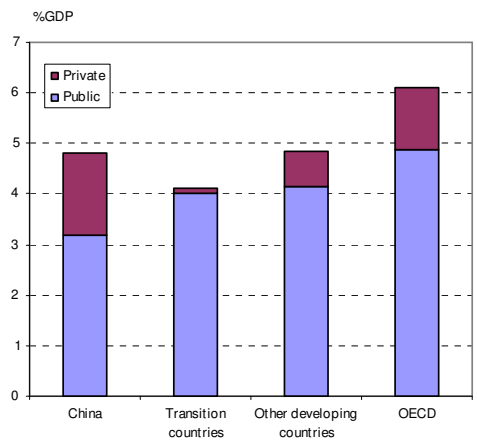
Not surprisingly, shifting the burden of health care to the individual has engendered large divergences in access, with health care becoming prohibitively expensive for poor people. A survey on the equality of access to health care by the World Health Organisation (WHO) in 2000 ranked China fourth from bottom.[168] The switch to a market-based system has also increased the gap between urban and rural regions, with poorer regions providing less health care.

In terms of health outcomes, China continues to perform well compared to other developing countries and even developed countries. For example, life expectancy has reached that of some OECD countries. However, there are signs that improvements are levelling off. For example, infant mortality rates declined dramatically from the 1960s to the 1980s but have since levelled off.[169]

8.5.2. Education

In order to continue to grow and move up the value-chain, China needs a well-educated workforce. This is a well-recognised challenge in China, and as evidenced elsewhere in this report, China is rapidly moving up on the ladder, in part thanks to a high level of relevant skills. It is therefore not surprising that education is a priority in China and the government has gone to considerable lengths to improve it.

Figure 8-7: Public and private education expenditure (2000)



Source: OECD (2005).

In terms of the level of funding, China overall spends a high amount on education, around 5% of GDP, which is only 1 percentage point of GDP less than the OECD average.[170] This makes it one of the most developed transition countries. However, the public share of that spending is much lower in China, amounting to 3.2% of GDP in 2002. Low public spending is compensated by high levels of private spending, amounting to nearly 2% of GDP in 2000. For example, spending on tuition fees as a share of total expenditure on education rose from 2.3% in 1991 to 12.5% in 1998.[171]

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[167] Donald and Benewick (2005).

[168] Ibid.

[169] Kanbur and Zhang (2003).

[170] OECD (2005).

[171] Kanbur and Zhang (2003).

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Education is the responsibility of local (sub-regional) authorities. As highlighted elsewhere, their levels of prosperity vary significantly. This inequality – which has increased significantly since the beginning of economic reforms – is reflected in their revenue-raising capacity and ultimately — and in spite of fiscal transfers between regions — in the level of expenditure they can afford.

It is therefore not surprising that the quality of education varies significantly between regions. Rich, urban regions generally have much higher standards while poor, rural regions typically find it difficult to provide even basic levels of education. This is reflected in education outcomes. While illiteracy, for instance, has decreased over the years, the differences between urban and rural regions have increased.[172] For example, the number of illiterate people aged 15 and above exceeded 25% in some regions in 2002.[173]

Education has been a priority in China during the last decade. The latest official goal was to spend 4% of GNP on education by the end of 2005. Despite higher spending, this objective proved elusive. China has also tried to devote particular resources to poor counties in order to extend compulsory education to 9 years schooling in urban areas and 6 years in rural areas. In spite of these efforts to focus spending on basic education, tertiary education continues to receive a higher proportion of public spending compared to primary and secondary.

[172] Kanbur and Zhang (2003).

[173] Donald and Benewick (2005).

01_2006_4142_txt_EN.indd 107 12-07-2007 10:43:39

9. DEVELOPING CHINA'S INNOVATIVE POTENTIAL

The importance the Chinese authorities attach to developing an innovative capacity is unprecedented. President Jintao stated at the National S&T Conference in Beijing in January 2005 that the goal was to transform China into a nation of innovation in 15 years. "Only when the efficiency of the whole national economy is considerably raised through technological and management innovation, can the country succeed in building a well-off society". A new phase of development based on innovation will avert the danger of relying excessively on low cost, to build and maintain China's competitive position in world markets in the future. Furthermore, given the increasing pressure that growth currently exerts on the country's resources and environment, embracing innovation as a way of tackling energy and environmental issues has become an inevitable choice. This new innovation phase is a daunting objective for China.

To bridge the S&T gap with the US, EU and Japan, China needs to boost its investment in public R&D and education infrastructure and improve the efficiency of public spending. But developing a national innovative capacity will require, over and above public S&T infrastructure, the right framework conditions for translating S&T expenditures into innovation and growth. This necessitates a sufficient 'demand' for innovation to reward and incentivate successful innovators, and hence end users willing to pay for innovation and effective intellectual property rights (IPR) schemes. Well functioning product, capital and labour markets and good industry-science links are needed to give innovators access to the necessary physical, financial, human and R&D resources. This is perhaps the most challenging aspect for China.

Opinions on the sustainability of China's S&T growth and its capacity to acquire technological leadership are diverse. To analyse whether China can succeed in developing its innovation capacity, we have to analyse its fundamental strengths and weaknesses and judge whether it can tackle its weaknesses and achieve its ambitious objectives by undertaking the necessary reforms.

9.1. China's strengths in building innovative capacity

China's **strength** in innovative capacity comes first and foremost from its large potential internal *market*, providing an enormous incentive for R&D investments for Chinese entrepreneurs. In addition, being close to the market is a major location factor for attracting multinational firms to site their R&D investments in China. But this is still mainly a potential strength, which awaits structural reforms to fully unleash its power.

Another important component of S&T growth in China is its huge *pool of human capital* for R&D. This is important in terms of attracting enterprises (both local and foreign) and research institutes to invest in R&D activities in China. Chapter 2 detailed the rapid increase in researchers and tertiary educated employees, most notably Scientists and Engineers. Stimulated by increased funding and reforms in the higher education system, the number of new students entering the higher education system has increased dramatically. And there is still a huge potential supply building up over the coming years, before the adverse demographic structure sets in.

Finally, political stability and leadership is important in terms of committing to a coordinated and coherent innovation policy in a focused way and with a long-term perspective. The current build-up of Chinese S&T capacity is supported by a targeted *S&T policy*, focusing R&D funding on specific areas where the contribution of the public

01_2006_4142_txt_EN.indd 108 12-07-2007 10:43:39

R&D to private R&D and growth can be best assured (cf chapter 2). This S&T policy is supported by a political leadership with a long-term perspective, who have put innovation on the long-term policy agenda (cf latest 11th 5-year plan).

9.2. China's challenges in building Innovative Capacity

Despite these nascent strengths, Chinese S&T policymakers still have many **challenges** to tackle.

9.2.1. Developing the public research infrastructure

First, there is the need to develop the *public research infrastructure* at public research institutes, universities and institutes of higher education.

(i) Public funding for basic research

The long-awaited new S&T plan, crafted by and to be implemented by the Ministry of Science and Technology (MOST), will set the tone for science in China for the next 15 years. R&D spending by all sources will rise to 2.5% of GDP by 2020. By 2010 it should have reached 2% of GDP, 40% of which will come from central government R&D.[174]

Basic research is slated to climb from 6% of R&D in 2004 to as much as 15% in 15 years. Most of this funding will be heavily concentrated in specific areas. The plan specifies 16 major engineering projects (including next-generation broadband, large scale oil and gas exploitation, transgenic plant breeding, drug development, manned moon exploration, design of large aircraft) and four major basic research programmes (protein science, quantum physics, nanotechnology and developmental and reproductive biology). Funding for these big programmes will be concentrated in a limited number of excellence centres.

A major source of funding for basic research is the National Natural Science Foundation. Set up in 1986, it was modelled on the US National Science Foundation. Its grant selection procedures are based on peer review involving mostly Chinese scientists-experts. More than half of its support goes currently to universities, the rest to government research institutes.[175] In the new plan, the NNSF budget is drastically increased to fund the big programmes specified in the plan. Nevertheless NNSF also plans to integrate the national strategic needs, specified through the big programmes, with an independent development of science scenario. One worry is the lack of transparency and open competition in allocating funding to these big programmes. Since almost all good scientists are involved in a big science project, there are not many good Chinese scientists left who can objectively evaluate. More internationally open evaluation procedures should be considered.

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[174] China's State Council.

[175] World Bank (2001).

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(ii) Reforming Public Research Institutes

In order to improve the efficiency of its basic funding, China has substantially reformed the public research landscape. As a legacy of the old system, Public Research Institutes (PRIs) conducted most of Chinese basic and applied research. Most of these PRIs operated in isolation from production activities. To respond to these problems, the government initiated major changes in the funding and management of these PRIs. The goal was to overcome the entrenched problem of research projects not being motivated enough by the actual needs of the market.

Box 9-1: Transformation of Public Research Institutes

Public research institutes are affiliated with government ministries or the Chinese Academy of Sciences. Within the Academy, the role of its 120 institutes has been redefined; their work has been refocused on priority areas and personnel have been upgraded. Many people have been restructured out of the picture. Research institutes which used to report to government ministries have been subjected to even more radical reforms. Some institutes were merged with existing SOE enterprises, while others were transformed into enterprises and others reorganised but remained as national research centres.

Source: World Bank (2001).

(iii) Reforming Research Universities

Universities are still predominantly active in Science & Technology Training. They have a significant capability for basic research but as yet represent only a small share of R&D effort. To get universities to contribute more to R&D, the Chinese government wants to distinguish between research and teaching universities. The number of universities has been reduced, concentrating into a smaller number of better scaled institutes, better able to meet top international standards. Funding is concentrated on top-notch universities and networks of excellence.[176]

The entrepreneurial spirit of the universities is remarkable. Stimulated by strong incentives (allowing researchers to keep at least 50% of earnings from commercialisation) new companies have spun off from university research. Universities have also invested in science parks and are expanding their cooperation with foreign and domestic enterprises, enabling universities to generate considerable extra income. This dynamism is a positive and unique Chinese asset. Nevertheless, clearer regulations are needed on how the results of research conducted as part of the universities' duties and publicly funded, may be exploited privately.[177]

(iv) Reforming Higher Education

Various reforms in the higher education system have been carried out since 1992, the overall objectives being to achieve both qualitative and quantitative growth.

In 1995, the so-called Project 211 was established by the Ministry of Education, and followed in 1998 by Project 985.[178] These projects focused on creating 100 key universities in China of world-class level. Beijing University and Tsinghua were singled

[176] China has called for the establishment of 100 first-class universities and 30 world-class research universities by 2020. Beijing University and Qinghua University in Beijing, and Fudan University and Jiaotong University in Shanghai qualify for meeting top international standards.

[177] World Bank (2001).

[178] Section based on F. Huang, "Qualitative Enhancement and Quantitative Growth: Changes and Trends in China's Higher Education, Higher Education Policy, 18, 2005, 117-130.

01_2006_4142_txt_EN.indd 110 12-07-2007 10:43:40

out to be the major receivers of funding, followed by a second tier of universities. Another measure has been the merger of specialised and smaller sized institutions into large scale comprehensive universities, more focused on research, and covering all academic disciplines. Merging of schools of higher education has helped to reform the management of higher education institutions, optimising the allocation of resources and improving standards. The Chinese MoE has also introduced a central system of quality assessment of teaching in Chinese universities, administered through the Centre for Assessment of Higher Education, which was set up in 2004.

In order to meet demand and policy targets, a large scale effort to achieve quantitative growth in Higher Education capacity has been made since 1999. Whereas the key universities were allowed to focus on qualitative enhancement, the quantitative expansion of Higher Education capacity has been achieved primarily in less prestigious provincial or local level regular higher education institutions. In addition, the private education sector has been supplying part of the required capacity.

Despite the initial strong quantitative take-off, significant issues remain to be tackled. First, despite the growth in quantity, there is a looming talent shortage. Companies, particularly in services sectors, and foreign firms are finding that graduates are top-heavy on theory and hard skills and are lacking the necessary soft skills like problem solving, project and team work and languages. Secondly, more emphasis needs to be placed on quality assurance. The Chinese government has already embarked on restructuring the higher education landscape into larger sized, full-curriculum institutions. But China should also seek to improve the quality of the system beyond the top-notch universities, by giving more autonomy to the institutions in developing programmes, admitting students, staffing and funding. It should integrate the growing private institutions into the formal education sector. Finally, it should tackle the problem of unequal access to educational services across provinces, by decentralising more educational authority to the provincial level and expanding distance education. If China fails to tackle the S&T inequality issue, a "dual innovation system" is likely to arise, with on the one hand a rapidly growing restricted number of knowledge-intensive institutions, locations and individuals and, on the other, the vast majority of the population with a low level of education and unable to benefit from China's knowledge investments. These knowledge gaps are reducing the effectiveness and dissemination effects of S&T investments and might even pose a threat to the future social and economic stability of China.

9.2.2. Developing private research

Secondly, and perhaps more challenging for China, *private research infrastructure* needs to be improved and better geared to creating innovative products and processes that support Chinese sustainable development. Direct support, by providing subsidies or tax credits, should use open transparent procedures and competitive allocation. But supporting private R&D investment goes beyond providing subsidies and taxes. It also implies putting the right framework conditions in place for firms to have incentives to invest in R&D.

First there is the issue of improving access to finance, especially for the smaller sized enterprises. Reforms of the financial sector (*cf below*) are important in terms of giving innovative firms access to financial capital to finance their R&D investments and growth. This is especially true of small, high-tech, high-risk start-ups. The Chinese venture capital market is still underdeveloped. Many venture capital companies are run by government officials with little skill in evaluating the technical and marketing potential

01_2006_4142_txt_EN.indd 111 12-07-2007 10:43:40

of start-up projects. In addition, venture capitalists have few opportunities to sell their ownership rights.

Second, product market reforms are needed to capitalise on China's huge market potential. This requires more reliance on competitive forces in product markets to reward the most efficient innovative firms. Reforms of product markets have been discussed above.

Enforcement of intellectual property rights (IPR) remains a major concern for foreign firms in particular, but increasingly also for domestic firms. One negative consequence of poorly enforced IPR protection is that companies will limit the amount and the nature of the R&D they do in China. While substantial legislative changes have been made, as a result of China's WTO accession, weak legal enforcement of IPRs make deterrence ineffective, dampening the incentives for firms to locate IP or develop local innovation activities in the first place. This is ultimately also against China's interests.

Box 9-2: Intellectual Property Rights in China

As part of their "open door policy", Chinese leaders realised that IPR protection would be crucial for attracting FDI. IPR legislation was essentially designed to reassure foreign investors. Since the 1980s, the State has promulgated a number of laws and regulations covering the major aspects of IPR protection. These include the 1984 Patent Law, the 1982 Trademark Law and the 1990 Copyright Law. China has also promulgated a series of rules for the implementation of these laws and has signed several international conventions, including the Patent Cooperation Treaty. In 2001, when it was admitted into the WTO, China made the necessary revisions to these laws in order to comply with the WTO's "Agreement on Trade Related Aspects of Intellectual Property Rights".

Administrative measures have played a very important role for IPR protection in China. Several government agencies are assigned to protecting IPR. They include the State Intellectual Property Office and MOFCOM. In 2004, China established the State IPR Protection Work Team, headed by a Vice-Premier of the State Council, responsible for planning and coordinating the work on IPR protection. Lately, especially after China was admitted into the WTO, it has gradually improved judicial protection for IPR. For example, the revised PRC Trademark Law, Patent Law and Copyright Law all established the judicial review system for administrative decisions.

China's major challenge is how to enforce the IPR legislation. Despite all the efforts taken to improve the situation, IP violations in Chine have been growing,[179] It is important to distinguish two issues: counterfeiting and piracy on the one hand, and patent infringements on the other hand.

With respect to counterfeiting and piracy, the main weaknesses are burdensome procedures for initiating and taking cases in courts, the complexity of the administrative organisational structure, with a lack of cooperation between and within enforcement agencies, a lack of enforcement at the local level and local protectionism, and lack of financial and human resources for the administrative enforcement agencies.

With respect to access to technology secrets and patenting, improved IPR enforcement should offer companies better protection, but the situation will remain far from perfect. This is particularly true for foreign firms, as in many key sectors China is seeking to extract technology and IP from foreign firms to support the development of Chinese industries. While companies should of course register their trademarks and patents and prosecute violators, litigation is likely to remain an imperfect means of protecting IP. The most successful companies complement their IPR strategy by adopting strategic and operational measures to protect their IP, thus lowering their litigation costs and improving the chances that their IP will remain safe. The best companies reduce the chance that competitors will steal their IP by carefully selecting which products and technologies to sell and manufacture in China, using secrecy and security measures, building in complexity in product and process design to make it harder to copycat, and managing the spillovers through researcher mobility, e.g. by building in non-compete clauses in labour contracts.

[179] EC (TRADE), 2006, EU Trade and Investment with China: Changes, Challenges and Choices.

01_2006_4142_txt_EN.indd 112 12-07-2007 10:43:40

Beyond focusing on the creation of know-how, the capacity of the Chinese S&T system to diffuse and absorb know-how needs to be further developed. User-producer interfaces need to be expanded. Also, private R&D should be more closely linked to the public research infrastructure, which means further improving industry-science links.

And finally China should open up its S&T system **internationally**. China needs to access the rapidly growing global knowledge base, by continuing to attract FDI, but also by improving the use of modern telecommunication/Internet. China needs to beef up its collaborative effort in international scientific initiatives. Although it has international agreements in S&T with more than 150 countries, active participation is low, both in terms of Chinese involved in projects abroad, as well as foreigners involved in projects in China (*cf above*).

9.3. Conclusion

China will not become a technological superpower soon. There are still several weaknesses and risks that need to be tackled. Building an innovative society requires an integrated policy at the highest level of the state. But taking into account China's determined growth performance in the recent past, it would be naïve to doubt that China will be making progress towards its targets, bringing its strengths into full play.

01_2006_4142_txt_EN.indd 113 12-07-2007 10:43:41

10. ABSORBING SURPLUS LABOUR

China's abundant and growing labour supply is obviously an important component of its success in world manufacturing. Almost 900 million people are in the age group 15-64, and they will reach one billion in 2015. The majority of these people live in rural areas and are unskilled. This pool of unskilled labour has underpinned China's economic growth over the past two decades.

At the same time, this abundance of labour may challenge the sustainability of socio-economic development when labour supply exceeds demand, leading to rising unemployment rates. The main challenge facing China's labour market in the coming years will be to absorb the surplus labour into quality jobs. Due to the restructuring process speeded up by China's WTO accession, China's state-owned enterprise sector may shed up to five million people annually in the coming years. The restructuring of the agricultural sector will also lead to dramatic reductions in the demand for agricultural workers.[180] In addition, China is experiencing a demographic boom that will increase the population aged 15-64 years at least until 2015, despite an increasing education level which keeps young people out of the labour market for longer. It is only in the medium to longer term, around 2035, that the ageing challenge will set in, to reduce the supply pressure.

A rise in unemployment would raise important challenges for the labour market in China. They could be limited by stronger economic growth, especially in the private sector and the more labour-intensive service sectors, which have generated the most jobs in recent years. Nevertheless, skills mismatch will be a problem. The sectors where China is building comparative strengths on world markets and where most of the growth is happening demand higher skills, which are not readily available among laid-off workers. The increase in productivity will reduce the demand for low-skilled labour, leading to major changes in the composition of employment. In addition, the skill bias is entwined in the rural-urban divide, with higher skills being more present in urban than rural areas. The upshot is substantial challenges for inequality and cohesion. It will also put a heavy demand on the Chinese educational system (cf below). Against this background, this section first reviews the main trends in the Chinese labour market before outlining the progress on reforms and discussing the main challenges that lie ahead.

10.1. Trends in China's Labour Market: rural vs. urban employment

The labour force participation rate in China is very high by international standards: in the late nineties, more than 80% of the working age population was on the labour market.[181] Most of the employment is in the rural sector, although the share of rural employment in total has been steadily declining, from 75% in 1980 to 66% in 2002. This is due to proportionately stronger and sustained employment growth in the urban sector: jobs in the urban sector have increased by 3% a year since the 1990s, while overall job growth averaged just 1%.

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[180] OECD (2005)

[181] IMF (2004)

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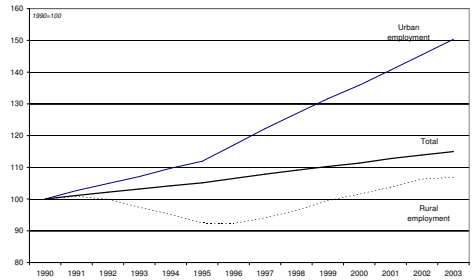
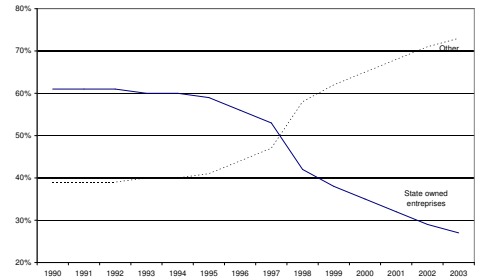
Figure 10-1: Employment and GDP

a. Urban and rural employment

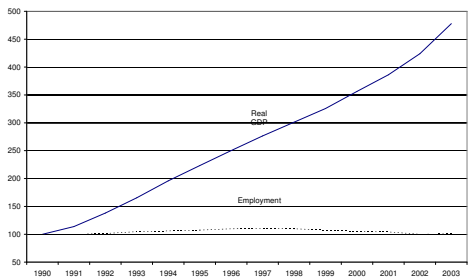


b. State owned employment

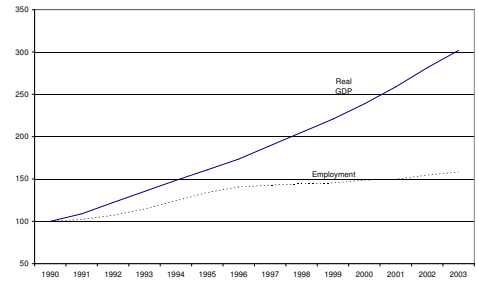


Note : share in urban employment

c. Secondary sector GDP & employment



d. Tertiary sector GDP and employment



Source: NBS, Statistical year books, various issues

Job growth in *urban* areas was achieved despite layoffs at SOEs equivalent to more than 10% of the urban labour force. The government's campaign to limit loss-making SOEs caused some 23 million state workers to lose their jobs between 1993 and 2003 (IMF 2004). These losses were more than offset by job growth in the private sector, including foreign-funded enterprises. The pace of job creation was much faster in the coastal provinces and in the service sector (cf chart 4-10). In addition, about 80 million jobs seem to have been created in 1995-2002 in the informal sector, although the quality of the labour market statistics makes it difficult to analyse these data.[182]

The majority of *rural* workers are employed on farms, although the share of farm employment in rural employment has been decreasing: from 91% in 1980 to 65% in 2002. Rural employment growth was more rapid in the late 80s and early 90s, especially in Town and Village Enterprises (TVEs), which increased their share in rural employment from 9% in 1980 to 27% in 2002. Nevertheless, overall growth in rural employment has been limited, especially since the late 90s and early 2000s as rural-to-urban migration increased.

[182] IMF (2004)

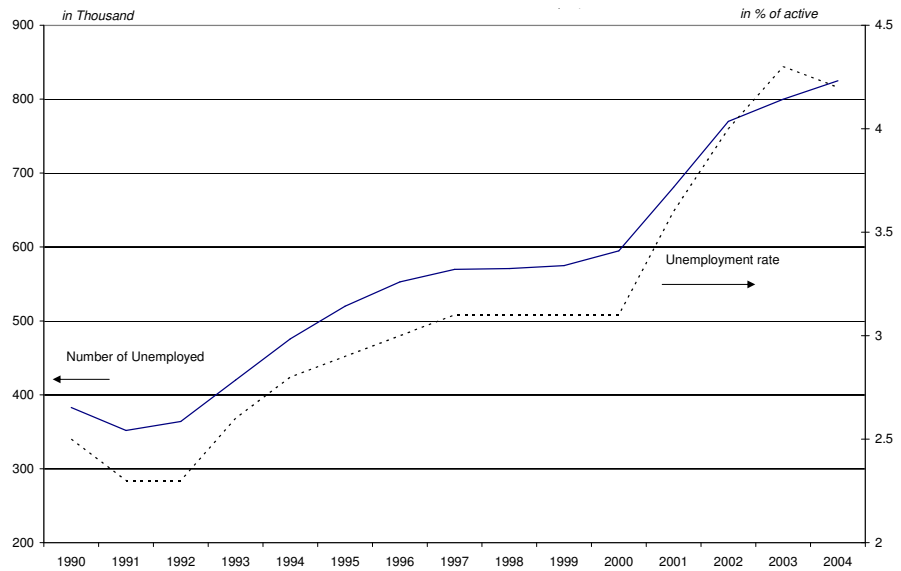
01_2006_4142_txt_EN.indd 115 12-07-2007 10:43:42

10.2. Unemployment: an understated phenomenon?

The poor quality of the data makes it difficult to estimate the true level of unemployment in China, particularly given the difficulty of calculating the scale of layoffs at state firms (see the issue of *xiagang* workers, cf below).

So far, there has only been a slight increase in registered *urban unemployment,* up from 2.5-3% in the 1990s to slightly above 4% in 2004.[183] If workers laid off from SOEs who remain registered with reemployment centres (*xiagang*) are taken into account, registered unemployment reached more than 5% in 2004. However, it is unclear how many of the *xiagang* workers in the informal sector can be considered as truly unemployed.[184]

Figure 10-2: Registered Urban Unemployment



Source : NBS, China Statistical Yearbook, various issues

With respect to *rural* unemployment, the low productivity of China's farmers compared with other Asian countries suggests a higher level of underemployment than elsewhere in Asia, although this is difficult to document with reliable statistics.[185]

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183 Gu (2004) and Cai and Zao (2004) cite alternative estimates of unemployment, with a rate around 7-8% for all workers.

184 The Chinese central government required reemployment centres to be set up in those state-owned enterprises that had laid off workers and staff members, cf below. It is unclear what proportion of *xiagang* workers should be classified as unemployed according to ILO guidelines, as they often work in informal jobs. Although many of these workers may want higher quality jobs in the formal sector, they are not strictly considered as unemployed so much as underemployed.

185 See for instance OECD (2002) and IMF (2004). OECD (2002), using the average level of productivity as a benchmark for the agricultural sector, estimates rural hidden unemployment to be around 200 million. Most of the other studies give a figure near 150 million.

01_2006_4142_txt_EN.indd 116 12-07-2007 10:43:42

10.3. Projections on China's labour market: can demand meet supply?

In the near future, the Chinese labour market needs to continue to absorb surplus workers from the rural and the SOE (State Owned Enterprises) sector. The supply of urban workers is likely to continue to rise as rural to urban migration and SOE restructuring continue, and as rural and urban enterprises downsize to increase efficiency in the face of world market competition.

In spite of earlier layoffs, much obsolete production capacity remains. For example, the government estimates that 15% to 20% of SOE employees could be released without affecting the output of their firms and outsiders.[186]

A potentially even bigger issue for the urban labour market, however, is the continued flow of rural workers migrating to the cities. A large proportion – estimated by the OECD to be as high as 200 million rural workers – is currently under-employed. WTO accession will entail further restructuring in rural areas.[187]

So far, the rapidly expanding private sector and the introduction of reemployment centres have helped to absorb the rising ranks of unemployed. The non-state-owned sector has, since 1992, provided more than 95% of the nation's new job opportunities. This growth is underpinned by tremendous productivity gains, leaving a relatively low employment elasticity. This raises the issue of whether output growth in the private sector can continue at a pace sufficient to absorb the larger supply of labour, particularly of the lower skilled. In this, the role of the currently underdeveloped services sector needs to be improved.

Table 10-1: GDP and employment

	Employment Growth rate %	Employment elasticity	Productivity Growth rate %
1981-1985	3.3	0.308	7.4
1986-1990	2.6	0.331	5.3
1991-1995	1.2	0.100	10.8
1996-2000	0.9	0.180	7.4

Source: NBS, IMF (2004).

IMF[188] projects that with a non-agricultural growth of 7.5% annually up to and including 2010, and an elasticity of employment growth to output growth of 0.45, the labour market can absorb about 3-4 million surplus rural and SOE workers annually in 2004-2006. This implies, however, that if most of the SOE downsizing takes place in the first years and rural migration takes place as targeted in the 10th Five-Year Plan, the unemployment rate could double to a peak of over 10% in the near future, but would decline again by 2010 as the natural increase in the labour force slows and SOE downsizing is completed. These projections are of course subject to a wide range of uncertainty. Nevertheless, they indicate the magnitude of the challenges that lie ahead for the Chinese labour market.

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186 OECD (2005)

187 See Ianchovina and Martin (2005), Carter and alii (2005). The latter estimate that WTO membership (with reform of the labour market) could entail a 25-50% decline in the agricultural labour force.

188 IMF (2002)

01_2006_4142_txt_EN.indd 117 12-07-2007 10:43:42

10.4. Labour market reforms

Given the pressures on the labour market, the government has been strengthening the social safety net outside the reemployment centres for urban workers. An unemployment insurance fund has been established, funded by mandatory contributions from employers and employees. Large regional disparities however exist, especially in rural area, where the insurance is only on a voluntary basis. More steps are needed to cover a larger part of the population (rural migrants, in particular) and to build a modern public employment system.[189]

To control migration, China had established in the mid-50s a system of household registration requirements (*hukou*). An urban *hukou* was needed to stay in cities and gain access to city services such as education, health and social security. Moreover, urban enterprises were restricted from recruiting labour from other provinces, thus hampering the development of a national labour market. Moves to relax the *hukou* system were initiated in the 1990s. However barriers to internal migration still exist, e.g. in the form of fees on rural migration movements and prohibitions on rural migrants working in certain sectors, which effectively block a national labour market.

Box 10-1: Hukou: a system of registration in progress

The current *hukou* registration system was designed in the early 1950s. Following a devastating famine in the 1960s, the government made it stricter by limiting the mobility of the population, notably the population flow from rural to urban areas.

One reason for limiting urbanisation was that the government considered farmers as an important resource for developing heavy industries. Accordingly, the government needed to tie farmers to the land so as to provide cheap agricultural products to the industrial sector. The registration system therefore tried to limit the number of subsidised urban residents.[190] While this contributed to industrial development, it made it all but impossible for farmers and rural workers to change residence.

Rural residents have since 1986 been allowed to purchase the right to reside in urban areas. The *hukou* system has since then been further relaxed, especially as regards medium-sized towns. Even so, the fear of migration has led some cities to return to stricter rules.[191] Moreover, in spite of reforms, the *hukou* system continues to impose a cost on migration. First, migrants must pay fees for temporary residence and/or doing business in urban areas. Second, migrants without permits do not have access to housing and health care benefits. Third, with a view to favouring the urban unemployed, rural workers with permits nevertheless face restrictions as to the job categories they can work in. Moreover, current regulations stipulate that urban firms cannot recruit labour from another province unless they can show that particular skills are in short supply.[192] In practice, though, cross-province recruitment exists, especially in big cities.

Overall, the *hukou* system binds a large labour surplus in the agricultural sector. It has also contributed to a segmented labour market between rural and urban workers. The application of these restrictions in an economy characterised by large urban-rural income differentials has contributed to a large "floating" population, i.e. persons residing in cities without resident permits. The size of this population is estimated at anywhere between 90 and 150 million, i.e. 13%-21% of the labour force.

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189 Reuterswärd (2005)

190 Carter (1997).

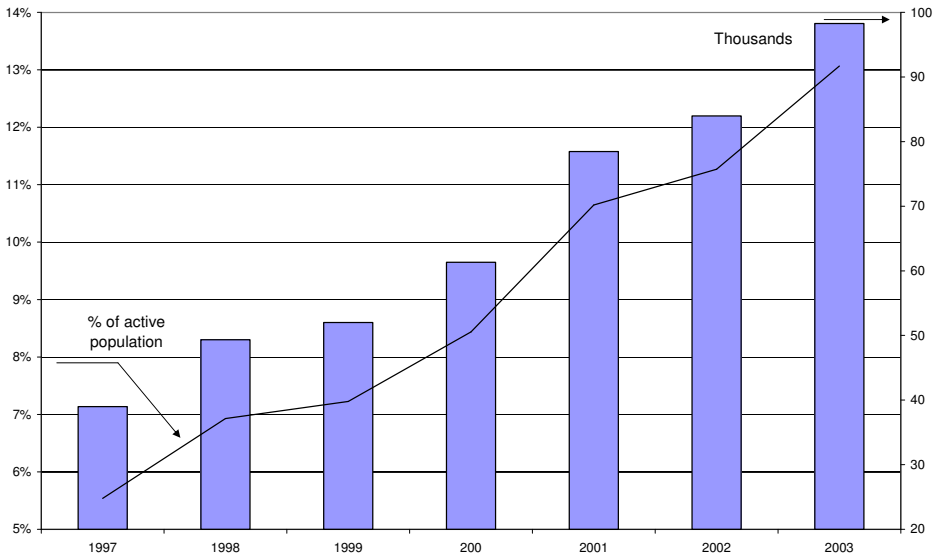
191 Carter and alii (2004).

192 OECD (2002)

01_2006_4142_txt_EN.indd 118 12-07-2007 10:43:43

The fragmented labour market comes at an economic cost. Accordingly, relaxation would bring economic benefits. Some studies suggest that these could be significant. In a recent paper, Ianchovina and Martin argue that abolishing the barriers to labour mobility would strengthen a process already unleashed by WTO accession, i.e. the flow of rural, former farm workers migrating to the cities. In general, a more mobile workforce would also do something to help reduce the large income differences between rural and urban areas.

Figure 10-3: Migration



Source : Betcherman (2004),

10.5. Conclusion

To address labour market pressures, the Chinese government should foster job growth in the private sector, which has been the main source of job growth in recent years. Removing the numerous barriers to growth that are still faced by private and public firms, as detailed in the previous sections of the report, is therefore a crucial priority.

In addition, although China has gradually moved toward marketisation of its labour market, especially in the non-state sector, further reforms in the labour market are needed, with greater flexibility in hiring and firing of labour, more labour mobility geographically and across sectors, enhanced worker skills, greater transparency of the labour market and stronger unemployment insurance schemes.

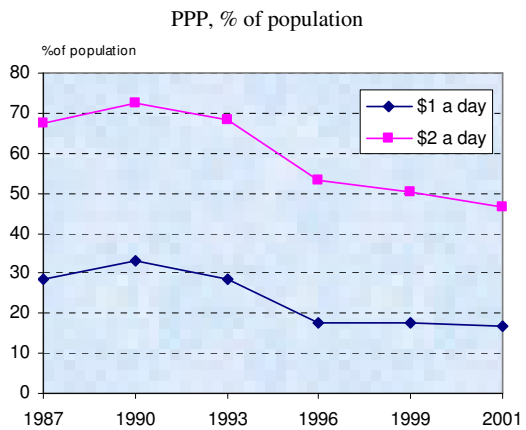
01_2006_4142_txt_EN.indd 119 12-07-2007 10:43:43

11. ADDRESSING THE INCREASE IN INEQUALITY

China has since the late 1970s enjoyed very high levels of economic growth, as this report has detailed. This has undoubtedly helped to lift many people out of poverty (how many, how much depends on the definition of poverty, see more below). However, while society as a whole has certainly become much richer, the rapid economic growth has not benefited everybody equally. Instead, inequality of economic outcomes has increased rapidly since the mid-1980s. From a fairly egalitarian – if poor – society, China has rapidly turned into a society characterised by fairly large disparities in income distribution, be they between persons, sectors or regions.

The reasons for the emergence of inequality on an unprecedented scale are manifold. While initial reforms in the early 1980s benefited the countryside, especially with the reopening of rural markets, reforms during the 1990s in the form of economic free trade zones and the like have primarily led to growth in the coastal zones, where China's secondary and tertiary sectors are predominantly located. However, inequality is further compounded by institutions. China is a segmented economy. Therefore, the kind of forces which would normally have contributed towards evening out income differences have been significantly reduced. For example, as outlined above, rural workers are discouraged from moving into towns and accordingly have difficulties exploiting economic opportunities. Moreover, China's welfare systems are rudimentary and do not redistribute resources to a significant extent.

Figure 11-1: Poverty headcount ratio at $1 and $2 a day



Source: World Bank (2005).

Moreover, China's system of intergovernmental fiscal relations – reformed in 1994 with the aim of increasing tax revenues and channelling more of these to the central government – perpetuates these differences. While local authorities have taxing powers, most of the revenue is transferred to the centre and then sent back according to certain rules-based criteria. However, these transfers are not designed to redistribute income. On the contrary, they go predominantly to the richer regions. As a result, while local governments have seen their expenditure mandates effectively increase, poorer regions are finding it increasingly difficult to find sufficient resources. Unfortunately, by acting more like a clearing house, the central government has little wherewithal to even out regional revenue differences.

The authorities are trying to put in place institutions aimed at addressing inequality while not undermining economic growth. This may be crucial. The open-door policy, compounded by the 1990s slogan of "some get rich first", has embraced capitalism but remains wedded to egalitarianism. It remains to be seen whether this system can sustain support should some parts of the country and some individuals seem to be more *perpetually* left behind.

01_2006_4142_txt_EN.indd 120 12-07-2007 10:43:43

11.1. Increasing disparities in economic outcomes

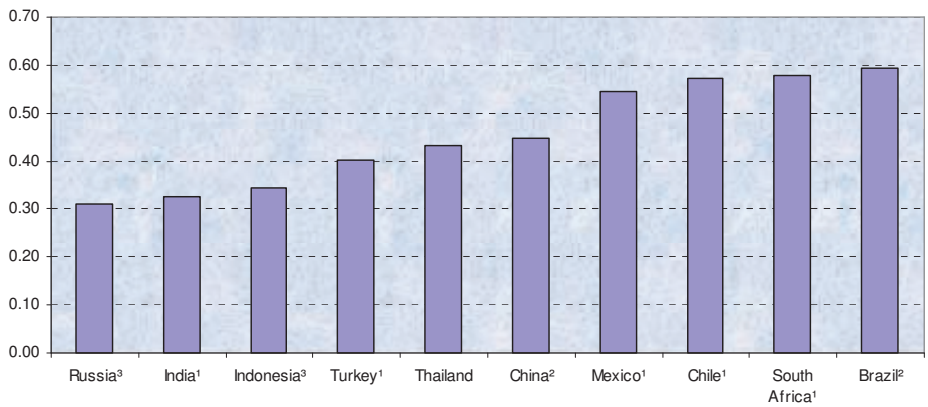
China's rapid economic growth has significantly reduced the number of people living in absolute poverty.[193] As documented by the World Bank Development Indicators, the proportion of the population living on less than US$1 per day has decreased from more than 30% in 1990 to 14% in 2002. Even so, these figures suggest that a sizeable part of the population remains poor.

While the increase in living standards associated with this growth has managed to significantly dent poverty, researchers agree that growth also appears to have been associated with increases in income inequality.[194]

Measuring income inequality is notoriously complex.[195] Results should therefore be interpreted with care. The following figure suggests that while inequality in China is higher than in e.g. Russia, India and Turkey, it still lags behind countries that for long have been plagued by high levels of unequal income distribution, such as Brazil and South Africa.

Figure 11-2: Inequality in China compared to other developing countries

International levels of the Gini coefficient



Note: The Gini coefficient measures the degree of inequality. Its value is between 0 and 1; 0 indicating perfect equality.

Source: World Bank (2005).

Even so, while experts disagree on the level of inequality in today's China, all surveys show that inequality has increased at a remarkable speed since the process of opening up the Chinese economy started in 1978. This illustrates how quickly China has gone from being a fairly egalitarian society – albeit at very low and decreasing levels of wealth – to a society characterised by rapidly growing, but unevenly distributed wealth.

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193 Li & Yi (2005).

194 See e.g. Benjamin et al (2005).

195 Domestically, the quality of data may not be high, as raw data may not be accessible or data may have too high a level of aggregation. As for country-to-country comparisons, definitions and measures of income as well as coverage over time may not be comparable. See OECD (2004) for further details.

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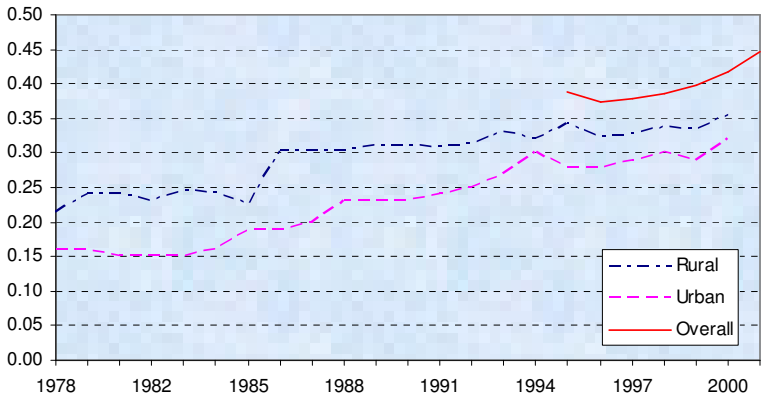
Figure 11-3: Inequality within China

Rural, urban and national Gini coefficients



Sources: Wenxiu (2004) and for 2001 overall rate, World Bank (2005).

However, some research suggests that figures measuring overall inequality need to be nuanced, suggesting that the gap between rural and urban incomes may not be as dramatic. A survey of 100 cities between 1988 and 1993 found that those cities where trade to GDP has grown more have seen decreases in inequality between its urban and neighbouring rural areas.[196]

Moreover, the above figure shows that inequality is much higher within the rural regions than within urban regions. Rural inequality increases at about the same speed as urban inequality, implying no catching up. Inequality within villages has increased, possibly due to differing access to education but especially differences of access to non-farm opportunities. With the latter comes wage income. Moreover, as agricultural prices closely follow global market conditions, the fall over recent decades has further depressed rural incomes. This cyclical income fall could become permanent should farm productivity increase.[197] The pressure on agricultural income levels is likely to be further accentuated should China continue the process of revaluing its exchange rate.[198]

11.2. Reasons for increases in disparities

There are several reasons why the rapid growth in China over recent decades has been associated with increased income inequality. Like many other developing countries experiencing rapid development, growth is unevenly balanced, favouring some regions, sectors and individuals more than others. These differences are partly reform induced, as reforms have been oriented towards coastal regions and policy has primarily focused on rural needs. However, disparities are also exacerbated by unreformed institutions that produce suboptimal outcomes in today's more market-oriented environment. The imbalances can also be explained by historical factors and past policy decisions. For example, regions have different resource assets, with some regions better equipped to

196 Wei & Wu (2001).

197 Benjamin et al (2005).

198 Blanchard & Giavazzi (2005).

01_2006_4142_txt_EN.indd 122 12-07-2007 10:43:44

profit from current patterns of economic growth. For example, while the East is not well endowed with natural resources, it has a favourable location, good transport infrastructure and a bigger pool of educated labour. It is in these regions that the first Free Special Economic Zones were created. The Western regions are on paper well endowed with natural resources, but their exploitation is hampered by unfavourable geographic conditions (e.g. little arable land) and long distances, bad infrastructure and accordingly high transport costs.[199] As regards rural income, traditional modes of organisation in the agricultural sector have suppressed agricultural income over centuries. Communist pricing policies compounded the income differences between rural and urban areas, as industrial products in urban areas carried higher prices. While initial reforms in the early 1980s favoured the rural areas – by allowing diversification of income streams and arranging for a fairer distribution of land – reforms have since primarily favoured the coastal regions.

However, income disparities are also compounded by *current* policies.[200]

- ***Dual economic structures***. Rural and urban goods and labour markets remain separated. The registered permanent residence system – "*hukou*" – makes it difficult for labour to circulate freely (cf above). A worker moving to another area loses the right to education and health benefits and cannot buy housing, as he or she is not allowed to register property. Accordingly, labour mobility is reduced. This undermines the economic forces of arbitrage, makes efficient resource allocation more difficult, and contributes towards perpetuating wage and other income disparities.[201]

- ***Policy preferences***. Policy has indirectly and directly favoured some regions over others, hence making it difficult for these to compete on even grounds. The East has been favoured since the early days of reform, both in terms of state investments and policy discretion. The Western regions have only experienced similar levels of freedom since the early 1990s. These differences are reflected in FDI inflows, as the richer, more better connected Eastern regions receive the great bulk of FDI and hence have been benefiting most from the development associated with FDI, cf chapter 1.

- ***Limited redistribution***. The increasing differences have not been counterbalanced by any policy measures such as taxation or social security. The *tax system* does not redistribute, as it only covers some income streams (wage, not capital), weighs more heavily on low income individuals and rural regions and is vulnerable to tax avoidance and evasion. *Social security* (e.g. unemployment, sickness and old age insurance) is only partially developed, has patchy coverage and is under-funded. Social security systems are more developed in urban areas. For example, annual per capita health care expenditure amounted to RMB 200 in Beijing in 2002. The corresponding figure for a central province such as Hunan was RMB 20.[202]

- ***Human capital differences***. A high level of human capital carries more material rewards in today's China than before. However, human capital is unevenly divided between East and West, with the former scoring higher on all levels of education (cf above). Policy has so far focused on boosting higher education, while neglecting

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199 OECD (2004), chapters 1-2.

200 See OECD (2004) for overview.

201 See Whalley and Zang (2004) for an overview of the economic effects of the "*hukou*" system.

202 IMF (2004).

01_2006_4142_txt_EN.indd 123 12-07-2007 10:43:45

primary and secondary education. This has been particularly detrimental to rural areas.[203]

11.3. Conclusion

Without killing off the incentives for growth, it is important for China to deal with the challenge of social cohesion. If unaddressed, the increase in income inequality and regional disparities may slow economic transition and act as a drag on future economic growth. If some parts of society are perpetually left behind, support for economic openness and reforms may erode. However, in view of China's rapid economic growth, resources should be available to ensure more effective support for those who lag behind, be it people or regions.

[203] OECD (2004), chapter 6.

01_2006_4142_txt_EN.indd 124 12-07-2007 10:43:45

12. ADDRESSING ENVIRONMENTAL CHALLENGES

China's leaders are very well aware of the need for a more balanced form of development that takes into account protection of the environment and national resources. The 11th five-year Plan (2006-2010) signals a notable shift from "growth" to "sustainable development", balancing the needs of people and the sustainability of the environment. Beyond the objective of doubling GDP per capita in 2010 compared to 2000, the other quantitative objective is to reduce energy consumption per unit in 2010 by about 20% compared to 2005. The objective is for China to choose a development path that economises on resources, using a "5-R" policy: Rethink, Reduce, Re-use, Recycle and Repair.

12.1. Pollution control

The quality of the environment remains a serious cause for concern in China. There has been progress in introducing pollution control. As a result, emissions of polluting gases rose less rapidly than energy consumption, which in turn has risen less rapidly than GDP. However, the level of both water and air pollution remains high. Several of the most polluted cities in the world are in China. Air pollution is mainly caused by the use of coal with a high sulphur content. Almost all of the nation's rivers are considered polluted to some degree. Half of the population lacks access to clean water. Most of the urban water bodies are severely polluted. Water scarcity is an issue in northern China, requiring large-scale diversion of river water, while the south faces flood risks.

China's leaders are increasingly paying attention to the country's environmental problems. The State Environmental Protection Administration (SEPA) was officially upgraded to a ministry-level agency. New legislation, introduced in 2003, has strengthened the use of financial penalties for the emission of air and water pollutants. But the major challenge is the effective monitoring and enforcement of laws by local agencies. An increasing share of the state budget is allocated to environmental protection. Beijing in particular has invested heavily in pollution control as part of its campaign to host the 2008 Olympic Games. China is also looking for new technological developments to meet the environmental challenges. Finally, the PRC is a participant in the climate change talks and other multilateral environmental negotiations.

12.2. Efficient use of national resources

China is not particularly well endowed with national resources to support its growth. For instance, 20 years ago China was the largest oil exporter in East Asia, whereas now it is the world's second largest importer. In order to reduce its dependency, China is devising a growth strategy that builds on energy-saving technology and the more efficient use of energy. However, this will not be sufficient in the short to medium term. China's access to foreign resources is necessary for continued economic growth. So state-controlled companies are being urged to secure exploration and supply agreements with countries producing oil, gas and other resources. For this, China is increasingly turning to resource-rich developing countries (e.g. coal from the Philippines, oil from Angola, Sudan and Ecuador, natural gas from Canada and Australia), raising important geopolitical concerns, as already discussed earlier.

01_2006_4142_txt_EN.indd 125 12-07-2007 10:43:45

13. Adapting China's political and Legal institutions to a transformed society

While the restructuring of the Chinese economy has been fairly rapid, China's political reforms have been more sluggish. So far the political reform effort has essentially aimed at adapting the existing political system to a new socio-economic environment by perfecting and reinforcing one-party rule, but not challenging it. The Chinese Communist Party (CCP) retains its grip on power, including its control of the military, and the leadership persistently argues that political stability is of the utmost importance for the country.[204]

There are two outstanding questions. First, can China in the longer run sustain economic development without restructuring its political system? In other words, can China's experiment of embracing the market and maintaining an authoritarian political system coexist for long? Second, how should China proceed towards a more democratic system without risking the chaos and instability everyone fears in China, in the neighbouring countries and further afield? These are important questions for a country like China that needs stability for its continued economic growth and, having learned the lessons of its recent history of turbulence and disorder, values political stability in its own right.

The White Paper "Building Political Democracy in China", issued in October 2005 by the State Council, can be viewed as China's response to Western criticisms over the pace of political reforms in the country. While it argues the case for China's type of "socialist democracy" and for the continued dominance of the CCP, it does not entirely reject the need for political reforms. The State Council refers to a number of areas where further progress should be achieved, such as 1) more political participation of citizens, 2) a better system of law enforcement, 3) continuation of the fight against corruption and excessive bureaucracy, 4) enhanced supervision over the use of power, and 5) a better public awareness of legal rights and obligations. The State Council further acknowledges that it will take time to achieve reforms in these areas: "there is still a long way to go in China's building of political democracy, which will be a historical process of continuous improvement and development." That position reflects the dominant perception among China's policymakers and influential thinkers. Democratising too rapidly – as Gorbachev did in the Soviet Union – would endanger the country's stability and growth.

13.1. A changing society

China is no longer a homogeneous authoritarian country. Chinese society has been going through profound changes. A 2005 GlobalScan report found that China was the country that showed the highest level of support for the free enterprise system and the free economy, with 74% of the respondents agreeing that it is the best system.[205] The Chinese people hold very high expectations about benefiting from their country's on-going economic expansion. A global study by the Pew Global Attitude Project shows that

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[204] President Jinag Zemin in an interview with the New York Times in August 2001 declared: "I can tell you with certainty: should you apply the parliamentary democracy of the Western world, the only result will be that 1.2 billion Chinese people will not have enough food to eat. The result will be great chaos.. Cited by YingMa, China's America Problem, Policy Review, 111, February/March 2002

[205] In China the survey was conducted in urban areas: Beijing, Chengdu, Guangzou, Hangzhou, Shanghai, Shenyang, Wuhan, Xi'an and Zhengzou representing 36% of the total population in urban China. Interestingly, the same report found that France was the one country where most (50%) disagreed with the proposition; only 36% agreed.

01_2006_4142_txt_EN.indd 126 12-07-2007 10:43:45

the Chinese have, in recent years, been happier than they have ever been in terms of improved living standards and are the most optimistic about their future, 72% of the respondents expressing satisfaction with their national conditions.

13.1.1. Emergence of a middle-class

More than two decades of economic reforms have led to the emergence of a new social group which enjoys higher living standards than the ordinary worker, owns properties such as cars and houses (by the early 2000s about 70% of China's urban households owned their home) but is not yet part of the richest strata. The "Blue Book of Chinese Society", an annual survey of China's social features published by the Chinese Academy of Social Sciences (CASS), shows that this middle-class is growing but it is not yet well formed.

Table 13-1: Self-identification measure

Social Stratum	Share of respondents
Upper	1.3%
Upper-middle	7.1%
Middle	38.4%
Lower-middle	23.2%
Lower	20.8%
Unclear	1.4%
No response	7.8%

(*Source*: Joseph Fewsmith, *Continuing Pressure on Social Order*, China Leadership Monitor, Issue 10, Spring 2004)

Li Chunling, a CASS sociologist, has tried to define China's middle-class on the basis of four main criteria: income, expenditure, profession and self-identification.[206] The self-identification criteria – people are asked how they view their own social standing – shows that 46.8% of the respondents identify themselves as middle-class or higher. According to less subjective criteria, only 4.1% of the population fits all the four criteria. Furthermore according to Li's findings the main features of the rising middle-class are that they are predominantly **young** (57% under 41), **urban** (64.6%) and **well-educated** (51.1% with more than high school education). Moreover, only 10% are Party cadres. Finally, one-sixth are enterprise managers, another sixth private enterprise owners, one-fifth specialists and technicians, and one-third office workers.

With the higher living standards come new interests to be defended, in particular as homeowners. That may lead to clashes with the government or other elites, as violations of homeowners' rights by the government or business actors are common. However it appears that it does not represent a new threat for Party rule and China's political order. A study of two significant cases of homeowners' protests subsequent to violations of their rights found that homeowners have limited political ambition and ability to take action.[207] The middle-class's first choice of action when resisting the State is to engage rather than to confront and to advance its interests without threatening the political order.

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[206] Li Chunling's work cited by Joseph Fewsmith in *Continuing Pressure on Social Order*, China Leadership Monitor, Issue 10, Spring 2004

[207] Yong Shun Cai, *China's Moderate Middle-Class. The Case of Homeowners' Resistance,* Asian Survey, Vol.45, Issue 5, 2005, pp 777-799

01_2006_4142_txt_EN.indd 127 12-07-2007 10:43:46

According to the same study, the moderate nature of the middle-class is determined by its interests being connected to the existing political order in one way or another.

13.1.2. The young urban entrepreneurs

With the boom of private enterprises during the last decade has emerged a young and well-educated urban economic elite. Some of the leading Chinese companies – such as SINOPEC, China's second largest oil company; China Mobile, the largest Telecom firm; China Construction bank, the second largest commercial bank; or Shanghai Baosteel group, the largest steel producer – have CEOs who are younger than 40. Many of these majored in engineering, a few received their degree from overseas, and several received their MBAs from the China-Europe International Business School (CEIBS) established in 1994 by the Chinese government and the European Union. According to several observers CEIBS has actually become a "cradle for China's CEOs".

The members of this young economic elite are increasingly being tempted into politics. Nine hundred private entrepreneurs nationwide participate in People's Congresses and 30 000 participate at various levels in People's Political Consultative Conferences (CPPCCS). This new elite is more than welcome by the CCP. For the first time ever, entrepreneurs of large companies and banks attended as a distinct group the 16th national congress of the CCP. The Central Enterprise Work commission and the Central Financial Work commission had their own delegations, and 17 representatives of the entrepreneurial class became members of the Presidium of the Party Congress, while 24 entrepreneurs from large SOEs, collective firms, joint ventures and commercial banks were selected to serve on the 356-member 16th Central Committee as full or alternate members.[208] A 2001 national survey found that 29.9% of private entrepreneurs were Party members (against 19.8% in 2000) and 90% of these joined the CCP before becoming private entrepreneurs.[209]

13.1.3. The return of foreign-educated Chinese

One of China's greatest strengths is without any doubt its population's hunger for education. In 1978 Deng Xiaoping decided to send students and scholars to study abroad. In 1992 the government drafted guidelines recommending support for students wanting to go abroad, encouraging their return and allowing them to come and go freely.

China's growing involvement in the international community has created an increased demand for in-depth research and analysis to provide the Chinese leaders with informed policy recommendations. It is not surprising therefore that the vast majority of the foreign-educated Chinese who returned to China now work in the fields of education, research, science and technology. In 2005 the Ministry of Education reported that about 60% of all the highest university principals are foreign educated.[210] Moreover, a large

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208 More recently the appointment of Miao Yu of Dongfeng Motor Corporation to become Party secretary of Wuhan has been widely reported in the Chinese media.

209 All the figures mentioned here are from Cheng Li, *The Rise of China's Yuppie Corps : Top CEOs to Watch*, China Leadership Monitor, Issue 14, Spring 2005

210 The Minister for education, Zhou Ji, is himself a foreign-educated Chinese. All the faculty members of the Beida Centre of China Economic Research, which regularly advises top Chinese leaders, have studied abroad, essentially in the United States, and these US-educated economists have largely redesigned the curriculum and research methods in economics and management in line with the American model, in particular the "Chicago model."

01_2006_4142_txt_EN.indd 128 12-07-2007 10:43:46

number of think tanks are led by foreign-educated scholars and several analysts have noted an interesting and "dynamic interaction between national power and interests and transnational knowledge."[211] A significant number of returnees are also involved in foreign trade and foreign affairs, banking, and finance. In Shanghai some 3 000 private enterprises were established by returnees. Nevertheless, on the whole China's political system is not very open to returnees. They play a political role only in the few fields mentioned above.[212] The share of returnees at ministerial and provincial levels remains fairly low; 13.6% among ministerial leaders and only 5.8% at provincial level are educated abroad.

13.1.4. The emergence of a new political generation

In China a political generation means a group of people born during a period of fifteen years and who have experienced the same major historical events during their formative years. The first generation under Mao is known as the "Long March generation", the second under Deng is the "Anti-Japanese war generation", the third under Jiang, the "Socialist transformation generation", and the fourth generation the "Cultural revolution generation."

The fifth generation of future leaders was born between 1957 and 1972. They have lived through a time of unprecedented economic and social transformation. Some of them have become strong market economy defenders; others harsh critics of capitalism. They are generally more educated than their predecessors and while the third and fourth generations' leaders were largely engineers by training, the leaders-in-being have studied economics, politics and law. They have experienced Tiananmen and they may fear a Tiananmen-like violent clash as the fourth generation fears a recurrence of the Cultural Revolution. They grew up in a more open and pluralistic society but they can hold strong nationalist views. All the members of the so-called Say No Club – the authors of a book series called *China Can Say No*, which expressed strong Chinese nationalism views – were born in the late 1950s-1960s.

The fifth generation is likely to be the most diversified elite generation in PRC history, not only in terms of views and values but also in terms of education and professional background. Some of the frontrunners of this new generation represent the rising entrepreneurs and the foreign-educated ones – the self-proclaimed "best and brightest" – others come from the local elites. They are Hu's main protégés, the so-called *tuanpai* who are starting to emerge in State Council ministries and top provincial leadership positions. Like Hu, they advanced their career through the Chinese Communist Youth League and received their leadership experience in inland provinces. They do not have any practice in foreign trade, finance or banking but they have a substantial experience in rural administration and Party organisation and propaganda. They are trustworthy supporters of Hu's "harmonious society" policy and effective agents for promoting it in the inland regions. By contrast the rising economic elite and the foreign-educated

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[211] Some of the most prominent aides to Hu Jintao have studied abroad. Xia Yong, Director of the State Bureau of Secrecy, studied at Harvard University (U.S.), Yu Keping, Deputy Director of the Central Bureau of the CCP was at Duke University (U.S.) then at the Freie Universität in Germany, and Wang Jisi, Director of the Institute of International Strategic Studies at the Central Party School was at Oxford University, then at Berkeley and University of Michigan in the United States.

[212] Although so far most of the foreign-trained Chinese have graduated in engineering, economics and management, a new trend has been emerging in recent years with many officials sent by central and local governments to study abroad public administration, law and international affairs.

01_2006_4142_txt_EN.indd 129 12-07-2007 10:43:47

Chinese come mostly from the coastal region and have never or rarely had any leadership experience in local governments. Over the past decade provincial leadership posts have opened the way to national leadership, but that may change.

What comes out of such a highly contrasted, almost dichotomous, new generation remains to be seen. It may lead to a more representative and pluralistic political system if complementarity overcomes divergence, or it could lead to tensions and power struggles.

13.2. A Communist Party in search of legitimacy

Polls conducted by the official national trade union in 1996 found that only 15% of the workers surveyed regarded communism as their "highest ideal" while 70% said that their top priority was to pursue individual happiness.[213] These results are in line with the GlobalScan survey referred to above. Obviously the Party's traditional ideology is no longer convincing, requiring the need for a new legitimacy.

13.2.1. Nationalism

"Nationalism is the sole ideology glue that holds the People's Republic together and keeps the CCP government in power. Since the Chinese Communist Party is no longer communist, it must be even more Chinese."[214] The Chinese leaders use nationalism to hold the country together. In the aftermath of Tiananmen, CCP leaders promptly presented themselves as the defenders of national pride and interests by resisting Western sanctions. From joining the WTO to standing firm against Taiwan's dalliance with independence or China being selected to host the Olympics in 2008, a number of events have helped feed this nationalist trend. The party redefined itself as a "Party of the people", becoming the vanguard of the Chinese nation and the Chinese people, and not only of the Chinese workers.[215] The CCP has been transformed from a "revolutionary party of the proletariat into a ruling party for the whole of the Chinese people."[216]

Moderate nationalism is supposed to foster political stability conducive to the continued economic modernisation on which the Party's popular acceptance is ultimately based. While "pragmatic nationalism" may have given a new legitimacy to the CCP it could equally create expectations that the Party may not be able or willing to fulfil. Nationalism is a double-edged sword and may unleash forces that the CCP cannot control, thus in the end potentially undermining the Party's standing.

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213 A survey of 818 migrant workers in Beijing in 1997-1998, although a highly selective sample, revealed that the prevailing image of the Party was the one of a "self-serving elite" widely corrupted. Minxin Pei, ibid

214 Thomas J. Christensen, *Chinese Realpolitik*, Foreign Affairs Vol. 72, n°5, September / October 1996

215 Looking at the correlation between economic reform and delayed democracy in China, Callagher (2002) shows how the Chinese regime has retained its legitimacy by reformulating the debate in 1997 over the privatisation of a large number of SOEs into a debate over Chinese national industry vs. foreign-invested industry. Privatisation was presented as a national interest once China had to defend the survival of its industry against competition from foreign industry. The socialist perspective and its core principles such as state ownership, "working class as the master class", and guaranteed employment have been replaced by a nationalist perspective and the ability of national industry to compete with foreign industry. Mary E. Gallagher, *Reform and Openness ; Why China's Economic Reforms Have Delayed Democracy*, World Politics , 54, April 2002

216 Gang Lin, *Leadership Transition, Intra-party Democracy and Institutions Building In China*, Asian Survey, Vol.44, 2, March/April 2004, pp255-275

01_2006_4142_txt_EN.indd 130 12-07-2007 10:43:47

13.2.2. Inner party democracy

After the traumatic time of the Cultural Revolution and the ensuing social chaos, the leadership publicly acknowledged that some political reforms were necessary. In a speech delivered in August 1980 – "On the reform of the System of the Party and State Leadership" – Deng Xiaoping called for an end to the over-concentration of power in order to avoid arbitrary rule, a separation of Party and government responsibilities, and a new system of leadership succession based on meritocracy.[217] Some progress has been made since then to enhance the Party's governing ability, and there is clearly a trend towards political institutionalisation that restrains individual powers.

- A two-term limit system (terms of five years each) and a mandatory retirement age (65) have been in place since 1985. For the national party leaders no formal retirement age rule was specified. In 1997 an informal age limit of 70 was applied to the election of Politburo members. At the 16th Party Congress in 2002 when Hu became new Party general secretary, all incumbent members of the Politburo over 70 years old retired without exception.

- Some electoral mechanisms have been introduced within the Party for elections to the Central Committee. In 1982 delegates were allowed to add and delete names to and from the list of nominees for the Central Committee provided by the leadership. In 1987 new election rules for the Central Committee required that the number of candidates must exceed the number of seats by five percent. This share remains the same today.

- Improvements in policy-making mechanisms aimed at overcoming the problem of concentration of power conducive to corruption have been tested in some places. They include decision-sharing, with important decisions left to the full membership of these Party committees rather than solely to the standing members or Secretaries.

- There is a clear interest in the professionalisation of the party leaders' management system so as to enhance the Party bureaucracy's efficiency and impartiality.

Public sector corruption has received much attention in recent years. In 2004, the Party intensified its anti-corruption campaign by publishing the Regulations of Internal Supervision of the CCP and Disciplinary Penalties of the CCP. However the problem continues. There are new worrying tendencies, such as an increased number of principals and young officials involved in corruption. At the same time, corruption is tending to go undiscovered longer.[218]

13.2.3. Grassroots democracy

When the People's Communes were disbanded in the late 1970s and early 1980s the Chinese farmers enjoyed the benefits of decollectivisation but were confronted with new difficulties such as shrinking incomes. Moreover, serious leadership problems emerged when leaders left their positions for more lucrative ones or, on the other hand, when there was an excess of power exercised by "local emperors-strong men". Soon rural China

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[217] Cited by Gunter Schubert, *Reforming Authoritarianism in Contemporary China : Reflections on Pan Wei's Consultative Rule of Law Regime*, Asien 94, January 2005

[218] Wen Shengtan of the Supreme People's Court.

01_2006_4142_txt_EN.indd 131 12-07-2007 10:43:47

slipped into a state of potential crisis. This triggered attempts to restore order. The response given by some was to introduce elections.[219]

The Organic Law of Village Committee adopted in 1987 stipulates that the chairman, vice-chairmen and members of village committees should be directly elected by the residents of the village. The Law started to be implemented in 1989. Over time the Ministry for Civil Affairs has introduced four criteria for democratic elections at village level: (i) the chairman, vice-chairmen and members of village committees must be directly elected by the villagers themselves; (ii) the number of candidates must be greater than the number of positions (competitive elections); (iii) voting must be by secret ballot; and (iv) the winning candidate must receive more than half of the votes.

It is still not easy to draw any overall conclusion from the experiment of elections at village level. There are 800 million people living in China's rural areas, with nearly a million villages, and the overall picture is very diverse. In some areas the elections are held properly, while other areas continue to experience problems such as corruption, and violations of the Organic Law. Foreign observers have witnessed elections only in a few villages. Nevertheless, on the whole it seems that when elections are held in strict accordance with the four criteria set by the Ministry of Civil Affairs they are followed by positive effects: those elected are younger, better educated and more entrepreneurial as well. While a majority of those elected are Party members a significant minority are not. Thus the village elections may become a recruiting tool bringing younger, more entrepreneurial and more popular leaders into the Party and subsequently enhancing the Party's legitimacy. According to the law, People's Congresses below the county level should also be elected directly but since the nomination process remains dominated by higher level authorities the experiment has not been conclusive so far.

Other political reforms have been experienced at grassroots level in some areas, notably prosperous ones such as Zeguo in Wenling municipality alongside Zhejiong Province's South-eastern coast. Democratic consultations on public policy issues have been organised since 1996 in order to enhance public participation in decision-making.[220] Citizens and Party representatives discuss important public issues, raise questions, express views and opinions. The sessions go into recess, during which the leadership discusses the proposals raised then announce the result to the citizens. Such consultations enhance both political legitimacy and social stability, and above all they do not challenge the rule of the Party.

13.2.4. China's civil society

In the wake of the social transformation unleashed by economic liberalisation, the government has recognised the need for civil society to assist in managing the consequences. The State has accordingly gradually transferred some of its functions to civil society organisations. For the optimists this is a signal that in the end the emerging civil society will be conducive to democracy. However, pessimists can argue that the

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[219] This response did not come necessarily from the more reform-minded leaders. Premier Zhao Ziyang, who was considered as one of the most advanced Chinese reformers, was opposed to elections at village level. He feared losing control over rural reforms and would have preferred to introduce political reforms in urban areas. Actually the debate was not about the advantages of democracy but whether political reforms would fuel or hold back chaos.

[220] Joseph Fewsmith, *Taizhou Area Explores Ways To Improve Local Governance*, China Leadership Monitor, Issue 15, Summer 2005

01_2006_4142_txt_EN.indd 132 12-07-2007 10:43:48

State has also developed a number of strict regulations to control the development and activities of those organisations.

The civil society organisations must register and they must have a sponsor approved by the government which will submit the registration request to the Ministry of Civil Affairs. The sponsor is legally responsible for any possible wrongdoings by the organisations and the law does not offer any incentives to potential sponsors. The obligation to renew the registration annually provides a useful tool of control. Civil society organisations are restricted in their ability to establish sub-divisions and branches, and the regulations forbid the establishment of two civil society organisations with a similar mandate in the same administrative region.

The term NGOs is often used to refer to foreign NGOs rather than to any Chinese organisations. The Chinese organisations closer to the Western concept of NGOs are (i) the social organisations (*Shehui tuanti*), most of which operate at local or county levels; (ii) the non-governmental and non-commercial organisations (*minban feiqiye danwei*), a large number of which deal with education and health issues; and (iii) the foundations promoting the development of scientific research, culture, education and social welfare.

The environmental civil society organisations are of special interest and importance as they fill a critical gap in the State's ability to address effectively the crucial environment issue. Therefore the Chinese authorities tend to adopt a generally positive attitude towards whichever organisations happen to work closely with the State Environment Protection Administration (SEPA), as they did for instance on a campaign about energy efficiency. The SEPA Vice-Director, Pan Yue, announced recently that SEPA will help to establish an environmental organisations cooperation network and provide professional training to small grassroots groups.

A survey of 22 environmental civil society organisations has shown that some of them did not experience state control and five were not registered at all and nonetheless conducted their activities openly without being bothered by the authorities.[221] The environment is indeed an area where the organisations have been allowed to work with limited political control, which is why some observers consider that this "has created the first independent grassroots movement that has been tolerated sine the CCP came to power in 1949."[222] On the other hand, it appears that the environmental organisations are good at handling their relative freedom, including by censoring themselves so that their activities do not provoke repressive state reactions.

The chambers of commerce offer another interesting case in point of the evolution of China's civil society and its interaction with State authority. They illustrate China's ability to develop new forms of administration adapted to the country's evolving socio-economic conditions and the Chinese leaders' capacity to accommodate to these new institutions. As there is a Subnan (southern Jiangsu Province) model of collective enterprises and a Guangdong model of enterprises with foreign capital, so there is a Wenzhou model of chambers of commerce and trade associations that has attracted much attention. Wenzhou, situated in the prosperous Zhejiang province, experimented in the 1980s-1990s with an impressive but chaotic development which ultimately led to profit erosion, in particular in the shoe industry, which acquired a reputation for low-quality

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221 U.S. Congressional Executive Commission on China, *Environmental NGOs in China : Encouraging Action and Addressing Public Grievances*, Statement of Jiang Ru, February 7, 2005

222 Oxford Analytica Brief, *China : Harbin Emergency*, November 28, 2005

01_2006_4142_txt_EN.indd 133 12-07-2007 10:43:48

production. Reacting to this worsening situation, the shoe industry was the first to organise itself and to think in terms of quality production and control improvements, and to develop a core of skilful workers. A Lucheng District Shoe Industry Association was established. The government, in cooperation with the new association, promulgated the "Management Regulations on the Rectification of Quality of the Lucheng District Shoe Industry" and the "provisional regulations on After Sales Service of the Shoe Industry." From there, chambers of commerce and trade associations grew quickly. In August 2002 there were 104 such non-governmental associations at city level and 321 at county and district levels.

The chambers of commerce and trade associations have always worked in close cooperation with the state through the Alliance of Industry and Commerce. However, the state's involvement in these associations' internal affairs has progressively diminished, and while the state still appoints a few chairmen, 77% of those associations report that they freely elect their chairman in accordance with their own rules. Observers note a growing trust on the government side towards these associations and in parallel an understanding on the side of the associations that they will be better off if they "promote their business interests without threatening the ultimate authority of the party."

Undoubtedly these different reforms towards better governance have helped enhance the Party's accountability and legitimacy, and even develop among the Chinese people a certain "democratic consciousness"; but they fall short of showing the Party really adjusting to growing socio-economic forces.

13.3. A dual approach to society

The administration is keen on addressing the issue of social unrest that challenges the country's stability and the Party's rule. The number of incidents has increased steadily over the last decade.[223] If the number of incidents is on the rise, it appears that the demonstrations are also better organised and are increasingly tending to turn violent. However, it is important to stress that so far there is little sign that the protesters are turning against the Chinese government *per se*. In responding to these protests, the government is sometimes more open, sometimes more repressive.

13.3.1. The caring approach

Since they gained power in 2002 both Hu and Wen have presented themselves as caring rulers. Many of their slogans are about "putting people first", "running the administration for the sake of the people", and "seeking harmony in the midst of differences." They have indeed paid more attention and devoted more resources than any other previous administration to people who have got "left behind", such as retired workers or peasants.

Some important policy changes have already been made to improve social harmony. Tax burdens on farmers have been reduced, and in late 2005 Hu and Wen announced the abolition of all rural taxes by the end of 2006. The State Council has ordered business firms and local governments to pay their debts to migrant workers, and over the next ten years the central government plans to provide professional training to unemployed

[223] According to the definition given by China's Ministry of Public Security mass incidents refer to "public order disturbances, obstructions of justice, gathering of mobs and stirring up of trouble." There were 10 000 mass incidents in 1994 and 74 000 in 2004. On 19 January 2006 the Public Security Bureau released the figures for 2005 that show an increase by 6.6% to 87 000 mass incidents recorded.

01_2006_4142_txt_EN.indd 134 12-07-2007 10:43:48

migrant workers. In 2003 the State Council decided that any additional resources given to education, health care, medicine, science and technology, and culture should in future be primarily invested in the rural areas.

The impact of these policy initiatives has been very positive. According to a CASS Survey conducted in 2004, 56.8% of respondents consider that the Chinese leadership has made important progress towards improving the lives of vulnerable social groups (against 9.2% in the 2003 survey).[224]

At this stage, it is difficult to know if the growing consideration given to vulnerable groups signals a profound change in state-society relations as argued by some Chinese scholars. It could well be that once Hu has consolidated his power he will be favourable to more open expressions of intellectual and societal opinions. For the time being Hu's priority is obviously to sustain stability in the political order at a time of leadership transition.

13.3.2. The repressive approach

However, the Hu-Wen administration is also known for its strict control over the media and the Internet. Moreover, there were recently disturbing signs that both central and provincial leaders had allowed the police and the paramilitary police to use force against demonstrators. Hu may be a follower of Mao's dictum "a spark from heaven can light up an entire plain", so better to crush a single revolt before it spreads across the country.

The new amendments to petitioning regulations in effect since 1 May 2005 stipulate that better consideration has to be given to the petitioners and that anyone who retaliates against petitioners as well as officials who fail to carry out their duties must be punished. On the other hand, the same regulations restrict petitioner activism.[225]

Tighter control is being exercised over the media and cultural institutions. Over the last two years, the Chinese government has launched a campaign to increase restrictions on the flow of information. Hundreds of illegal political publications have been banned, a licensing system for reporters not affiliated with official media outlets has been established, and new registration requirements for websites have been imposed. In early January 2005, the head of the Publicity department of the CCP's central committee signalled that controls over publishing, the Internet, and short messaging systems (SMS) would be significantly tightened to ensure social stability. In September 2005, new regulations were introduced on Internet news, prohibiting the distribution of uncensored versions of e.g. a news event.

John Palfrey, executive director of the Berkman Center for Internet and Society at Harvard Law School, considers that fear "has led the Chinese government to create the world's most sophisticated Internet filtering regime", known as the "Great Firewall of China". Some of the world's most famous companies have bent to Chinese demands for restricting and controlling Internet access.[226] According to *Reporters without Frontiers*,

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[224] Cheng Li, *Hu's Policy and the Tuanpai's Coming of Age*, China Leadership Monitor, Issue 15, Summer 2005

[225] Human Rights Watch – World Report 2006

[226] John Palfrey, *OpenNet Initiative Testimony Before the U.S.-China Commission – "Internet Filtering in China in 2004-2005*, April 14, 2005

http://www.opennetinitiative.net/studies/china/ONI_China_Country_Study.pdf

01_2006_4142_txt_EN.indd 135 12-07-2007 10:43:49

"Cisco Systems has sold several thousand routers to enable the regime to build an online spying system and the firm's engineers have helped set it to spot 'subversive' key words in messages." All the companies helping the Chinese authorities insist that they are merely obeying local laws.[227]

13.4. Improving the legal system

13.4.1. From rule of man to rule of law

One of the most significant challenges the West is facing in its dealings with China is the enforceability of regulations and legal commitments. Chinese law is based on the principle that the state has primacy: the rule of man (*ren shi*) as opposed to the rule of law (*fa shi*). However, since the Reform Era, China has accepted the need for a legal base offering greater legal certainty and transparency for economic activities to develop. But as this legal framework is developing, there is still a lot of experimentation and learning going on.

The reform of China's legal system has been one of the most important changes in China during the process of economic modernisation. However, the progress made in building a modern legal system looks mixed. Indeed, over the last 25 years China has passed nearly 400 laws that have laid the foundation for a modern legal system, and (i) administrative laws have been modernised, (ii) the criminal code has been improved, (iii) the Constitution has been amended to include the protection of human rights and private property rights, (iv) Chinese citizens are increasingly using the legal system to protect their personal and property rights and they have also begun to sue local governments for abuse of power, and finally (v) the number of lawyers has increased from a few thousand in the early 1980s to more than 100 000 in 2002, and lawyers and judges are better trained today than in the past.

However, China has not yet established a genuine modern legal system or rule of law. The main weaknesses relate to a lack of judicial independence (the Court system is controlled by the Party) and weak judicial authority (Chinese courts lack the political authority to enforce their decisions). Other reasons are a lack of respect for the law (laws are not enforced or are ignored by the government itself), the reluctance of the CCP to allow real judicial constraints on the exercise of its power and, finally, judicial corruption (in public perception the Chinese judiciary is one of the most corrupt government institutions).

The Chinese leadership is aware that greater professionalism, independence and integrity should be brought to the judiciary. The Second Five-Year Reform Programme for the People's Courts (2004-2008), issued recently by the Supreme People's Court, goes in that direction. It assigns some 50 goals for Court reform (revising adjudication procedures for death penalty case is the first stated goal). However the document also reasserts the leadership of the Party and the supervisory power of the people's congresses at all levels.

13.4.2. Enforcement and implementation

Weak enforcement of improved legal and regulatory frameworks has been a recurrent theme of China's economic reforms, ranging from enforcement of contracts, commercial

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[227] Jonathan Mirsky, *Censoring the Internet*, International Herald Tribune, 16 January 2006

01_2006_4142_txt_EN.indd 136 12-07-2007 10:43:49

codes, competition law, to environmental codes. The Chinese authorities are committed under their WTO agreements to improve judicial enforcement of contracts and other business codes, including those governing intellectual property and counterfeiting. However, there has been little fundamental change in the judicial mechanisms for enforcement. Neither the independence of the courts nor their jurisdiction are adequately established. Although the Chinese constitution states that judicial proceedings are to be free of interference from other government and political entities, judges, courts, and other judicial organs remain under their supervision and dependent on them for funding. The legal obligations of other government entities to enforce or obey court decisions are not adequately established, and court decisions are often ignored as a result. Enforcement is further hampered by the limited experience of China's courts with civil law proceedings, and the limited training of judges and other judicial personnel. To improve enforcement the key objective is to strengthen the independence, clarify the jurisdiction of courts, and to invest in building up legal know-how.

13.5. Conclusion

China is living through a time of increased social unrest, viewed as potentially destabilising for the regime. The Hu-Wen administration is perfectly aware of the urgency of addressing China's problems, and acknowledges that, important as economic efficiency is, it should not come at the expense of distributive justice. The administration is aware that official corruption is one of the main causes of people's resentment and is publicly committed to fighting corruption.

Nevertheless, while the restructuring of the Chinese economy has been fairly rapid, political reform has been lagging behind. Some progress has been made (e.g. the policy of modernisation and professionalisation of the bureaucracy, the opening-up to entrepreneurs in the Party, the organisation of elections at grassroots level, and the development of a civil society in the country). Furthermore, in the face of rising social unrest and rampant official corruption, the new Chinese leadership seems to stand for more transparency, greater accountability and more distributive justice. Those positive signs towards changes in policy direction should not be underestimated. However, so far the political reform has been geared essentially towards adapting the existing political system to a new socio-economic environment by perfecting and reinforcing one-party rule – not by challenging it. Fundamentally, the CCP retains its grip on power, including its control of the military.

Despite the slow pace of political reforms, it seems that a strong majority of the urban and rural population supports the regime thanks to China's successful economic development, its self-affirmation as a strong nation (in particular the reunifications with Hong Kong and Macao represent the achievement of national goals), and the regime's ability to preserve political stability. Many are convinced that the regime has saved China from a fate similar to that of the former Soviet Union. Moreover, a degree of pragmatic nationalism helps the government to hold the country together. However, aggressive nationalism that might get out of control would risk undermining the conditions conducive to the country's continued growth.

China's society is increasingly diverse, and new interests have emerged. It appears that the profound changes have been accompanied by an increasing accommodation between the political system and the interests of this more diverse society. The state-society relationship is based on a very strong convergence of interests that for the time being seems to enable the government to give some relative freedom to a number of social groups, while these groups know perfectly where their limits of action are.

01_2006_4142_txt_EN.indd 137 12-07-2007 10:43:49

A new, better-educated and more open generation is emerging. But that does not necessarily mean that the Party's rule will be challenged. On the contrary, the CCP has shown that one of its greatest strengths is its faculty to adapt to changing times. Furthermore the new generation is no less nationalist than its predecessors. Such accommodation may delay for some time any real political liberalisation. Instead, the new generation is reflected in the Party leadership, where a new and heterogeneous political generation composed both of party officials, private entrepreneurs, and a foreign-educated elite is emerging. However, it remains difficult to say whether this will be for the best – a more balanced, representative and pluralistic political system – or for the worst – a harsh struggle for power.

If the political opening at the top is pursued and if it is combined with bottom-up pressure, it may well lead to the emergence of a new Chinese political era conducive to genuine political reform. However, this is far from certain.

01_2006_4142_txt_EN.indd 138 12-07-2007 10:43:50

PART III: WHAT CHALLENGES IS EUROPE FACING?

China's rise provides significant opportunities for the EU. China offers an important market for our exports and provides a wider variety of increasingly high-quality, low cost imports for consumers and firms alike.

However, the emergence of China also presents the EU with a set of challenges. One set is economic in nature. China's rise, like international trade in general, strengthens the opportunity to specialise according to comparative advantage. Specialisation requires a continuous reallocation of resources to sectors where the EU has a comparative advantage. Well before the advent of China there were signs that this reallocation process was not working as smoothly as it might in Europe. For example, workers who are made redundant by trade shifts do not easily find a job elsewhere. While China does not add anything qualitatively new in this respect, it nevertheless accentuates the problem by dint of its size and largely unprecedented speed of development. This pace is unlikely to diminish markedly in the years to come. On the contrary, there are signs that China is gaining a comparative advantage in sectors that are increasingly important for Europe, e.g. electronics, mechanical engineering and, potentially, car making.

Another set of challenges relates to the political side. China's foreign policy has so far been more or less entirely devoted to ensuring favourable conditions for economic development. Gradually, however, China is likely to use its increasing economic might by exercising more political clout. It is already becoming increasingly assertive on the international stage. This is an entirely natural and welcome development, as e.g. illustrated by China's constructive role in the international talks on North Korea. Nevertheless, it is natural that the emergence of a large country with its own history, set of preferences and interests may lead to differences of views. For example, in its quest to secure energy, China has not hesitated to engage with countries that the EU and the international community at large have decided to shun. Moreover, Europe and China continue to hold differing views on e.g. political participation, human rights and the rule of law. There are also potential challenges that the EU needs to consider, arising from China's actions and intentions vis-à-vis its partners in the East Asian region and the region's main security provider – the United States.

Overall, Europe needs to adjust to the new reality of an increasingly wealthy and assertive China. The EU's policy vis-à-vis China should therefore focus on a number of objectives. First, the EU needs to improve its understanding of where China stands and where it is going in order to place policy on a firm foundation. Second, in view of the importance of a wealthy China and its orderly integration into the international system, the EU should assist China in overcoming the challenges of transition and reform. Third, to cope better with economic competition from China, the EU needs to improve its competitiveness and ability to adapt. Fourth, to reap the full benefits of China's economic opportunities, the EU needs to get China to strive for effective market access reciprocally. Finally, the EU needs to continue to anchor China firmly in the international system and continue to engage in an ongoing dialogue of where the system should be heading and defend views that we hold dear.

01_2006_4142_txt_EN.indd 139 12-07-2007 10:43:50

14. THE ECONOMIC IMPACT OF CHINA'S RISE

This chapter discusses the impact of China's growth performance on economic relations between China and Europe. Its focus on the EU complements chapter 3, which discussed China's impact on the world in general. Like other countries and regions, a growing Chinese economy provides great trading potential and investment opportunities for European business, and offers EU consumers a wider variety of better priced products. It may also present specific challenges for the EU economy, as this part of the report will demonstrate. Section 1 discusses EU-China trade patterns and competitiveness trends. Section 2 discusses European FDI flows into China [228] while section 3 discusses the role of European Multinational Firms in China's international division of labour.

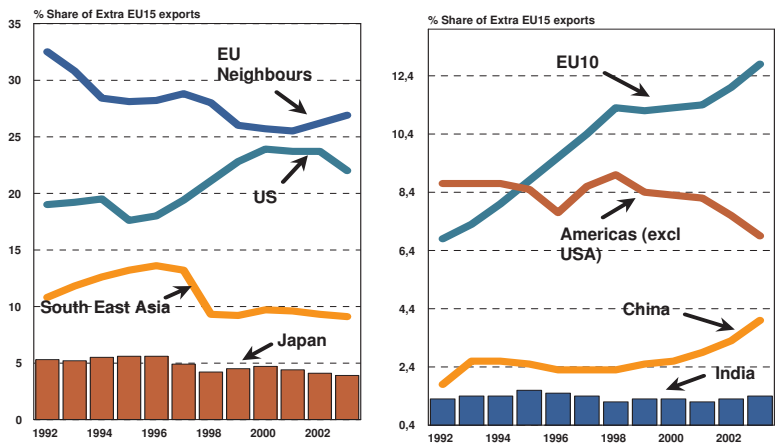
14.1. EU trade and China

14.1.1. Overall Trade Position

The principal driver of recent European trade growth has been increased integration in an enlarged Europe, between the EU-15 and EU-10. However, growth in extra-EU trade has been most pronounced with China. In 2005, China become Europe's second most important external trade partner, behind the US.

EU-15 **exports** to China grew annually at 9% over the period 1995-2002.

Figure 14-1: Shifts in the Geographical Focus of EU-15 Exports (Manufacturing)



Source: European Commission (2005b).

However, China's importance for the EU is primarily as a market to source **imports**. Imports from China have grown faster than exports to China, rising by 17% per year over the last five years.

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[228] For an analysis of the consequences of the increased attractiveness of China as a destination of foreign investment for the European economy, see also Belessiotis, Levin and Veugelers (2005).

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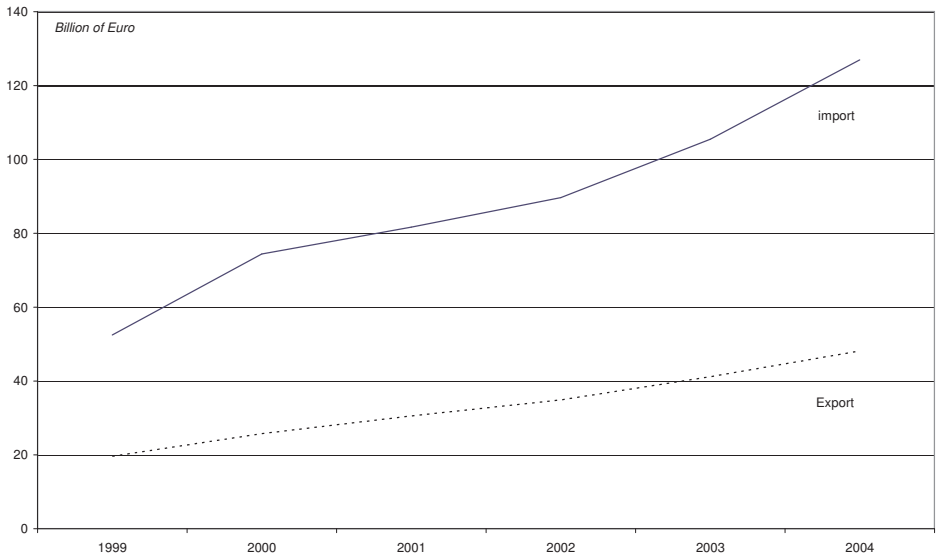
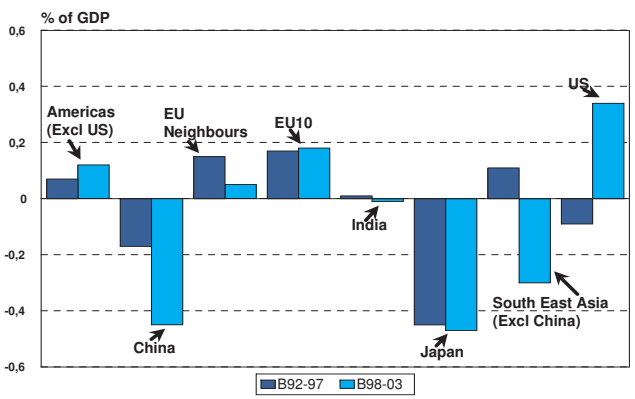
Figure 14-2: EU-15 trade with China



Source: Eurostat

This unbalanced trade structure has led to the emergence of **growing deficits** in China-EU trade, as the following graph documents. Trade deficits are not unique to China, however. All three areas of Asia have opened up significant trade gaps with the EU. The trade deficit with China of nearly 0.5% of GDP is at similar level to that with Japan. These deficits at the bilateral level are to a large extent offset at the aggregate level by the buoyancy of the US market, where the EU has seen a sharp turnaround in its trading position.

Figure 14-3: Extra-EU-15 Trade Balances



Source: European Commission (2005b).

01_2006_4142_txt_EN.indd 141 12-07-2007 10:43:51

The surge of imports from China to the EU has to a considerable extent been boosted by EU trade measures. China has since 1980 been included in the Community System of Generalised Tariff Preferences (GSP) and has become one of its greatest beneficiaries. The value of imports to EU Member States from China that were under the coverage of the GSP in 1995 amounted to 53.6% of total EU imports from China. Since then the EU has been phasing out GSP preferences towards China.

14.1.2. Trade Position by Member State

Germany is the largest Member State exporter to and importer from China. In 2003, Germany accounted for €18.3bn or 44% of total EU exports to China, followed by France (€4.7bn or 11%). In turn, Germany was also the largest importer from China (€22.5bn or 21%), followed by the United Kingdom (€17.3bn or 16%), the Netherlands (€14.7bn or 14%), France (€9.6bn or 9%) and Italy (€9.5bn or 9%).

14.1.3. Trade Position by Sector

More detailed data by product groups suggest that the EU-15 trade balance with China worsened between 1996 and 2002 in nearly all of the broad product groups. The only exception to this among the biggest industries is trade in chemicals, where the improvement was caused primarily by the soaring Chinese demand for intermediary goods.

Table 14-1: EU-15 Trade with China by Broad Product Groups

Product groups	Exports		Imports		Trade balances		
	2002	Growth[a)] 1996-2002	2002	Growth[a)] 1996-2002	2002	1996	Changes 1996-2002
	€ mio	in %	€ mio	in %	€ mio	€ mio	€ mio
Total manufactured products	37016	8.9	47389	14.5	-10373	1,992	-12366
Of which:							
Food products, beverages and tobacco	546	-2.8	1097	2.2	-551	-277	-274
Textiles and textile products	696	10.0	6810	8.6	-6114	-3455	2658
Leather and leather products	452	13.7	2537	9.0	-2085	-1201	-884
Wood and wood products	251	38.8	587	4.5	-336	-405	69
Pulp, paper and paper products; publishing and printing	1101	20.3	248	17.7	853	223	630
Coke, refined petroleum products and nuclear fuel	59	25.6	338	3.4	-279	-256	-24

01_2006_4142_txt_EN.indd 142 12-07-2007 10:43:51

Chemicals, chemical products and man-made fibres	4867	15.9	2955	5.5	1912	-297	2209
Rubber and plastic products	513	23.0	1517	14.7	-1005	-460	-545
Other non-metallic mineral products	358	6.1	755	9.8	-397	-155	-242
Basic metals and fabricated metal products	2938	12.4	3019	8.4	-81	-426	345
Machinery and equipment	11450	4.1	4379	21.7	7072	7542	-471
Office machinery and computers	942	33.6	6556	31.3	-5614	-1313	4301
Electrical machinery and apparatus n.e.c.	2961	13.0	2826	22.0	135	382	-246
Radio, television and communication equipment and apparatus	3088	4.8	5988	23.4	-2900	289	3190
Medical, precision and optical instruments, watches and clocks	2236	17.5	1293	14.6	943	34	909
Transport equipment	4308	8.8	1938	30.9	2369	2092	277

a) Average annual growth rate.

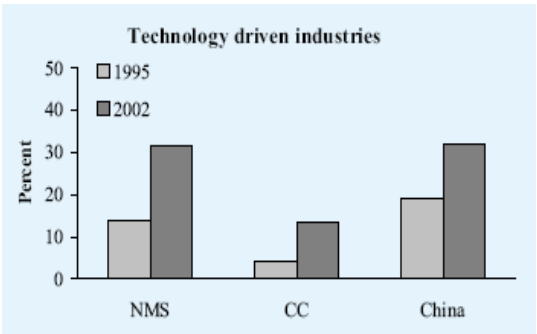
Source: EC-DG ENTR, Competitiveness report 2004

Source: European Commission (2005a).

In line with the general trend in Chinese exports, as reported in Part I, the data for the EU-15 show a remarkable growth of Chinese exports to the EU-15 in high-technology sectors. This is not exclusive to China. The new Member States and candidate countries' exports of computers and telecommunication equipment into the EU-15 also show strong growth. As regards labour-intensive exports, these are more important for the candidate countries than for the new Member States and China. Overall, this suggests that China should not be seen solely as a low-cost producer. It is increasingly moving into high-technology sectors, further challenging Western economies.

01_2006_4142_txt_EN.indd 143 12-07-2007 10:43:51

Figure 14-4: Share of Manufacturing Exports to the EU-15 by Type of sector



NMS: New Member States; CC: Candidate Countries (Bulgaria, Romania, Turkey

Source: European Commission (2005a).

Box 14-1: China, the EU and IT[229]

As already discussed in chapter 2, China is becoming the hub of electronics manufacturing in the developing world and is a key link in the value chain of many electronic products, particularly in PCs, peripherals and mobile handsets. This Box analyses the implications for EU firms of China's rise in IT.

China's performance in electronics has been impressive and is likely to continue. Aiming to establish the whole value added chain in China, it will try to become less dependent on imports of upstream components for the assembly of electronics. Its (potential) comparative advantage is strong and growing in production equipment and semiconductors. These sectors are currently dominated by US enterprises, which will be affected badly. For European firms, with no strong comparative advantage in IT sectors, there are only a few opportunities to export to China, and then only in areas where EU firms can command sustainable technology leadership. This concerns, for instance, the installation and upgrading of infrastructure for telecommunication operators. At the same time as China is taking its place in world markets, Europe will face growing imports of preassembled components. Final assembly will take place within Europe, close to final customer markets. This implies inward FDI from China.

[229] Based on European Commission (2005a).

01_2006_4142_txt_EN.indd 144 12-07-2007 10:43:52

Box 14-2: China, Textiles, the EU and the WTO [230]

China has become the focus of considerable debate recently following the liberalisation of textile quotas with the expiry of the Agreement on Textiles and Clothing on 1 January 2005. Over the period 1996-2002 China's trade surplus with the EU-15 in textiles and textile products was €2.7bn and has since increased further. China is competing in the EU textiles market with other foreign producers. Between 1995 and 2004 China's market share in textiles and textile products in the EU-15 rose by some 4 percentage points (to 43.3%) as did the share of Bangladesh (to 8.7%) followed by Turkey's growth of 2.6 percentage points (to 22.6%). These increases have been at the expense of Egypt, India and the Maghreb (Algeria, Morocco and Tunisia): countries which together have experienced a decline in market share of some 10 percentage points during this period. The share of textiles and textile products in China's total exports to the EU-15 declined by close to 10 percentage points between 1995 and 2004. The data confirm the EU's comparative disadvantage in these products and the substantial gains from trade China's emergence in the international trading system offers.

14.1.4. EU-China competitiveness trends

To assess how European firms will be affected by China's rise we have to compare the profile of sectors in which both China and Europe are developing a comparative advantage. This analysis, although the data are unfortunately not the most recent, suggests that there is a degree of **complementarity between** developments in **China's and the EU-15's comparative advantages**, as table 14.2 illustrates.

In most areas where China shows decreasing trade competitiveness, the EU-15 shows a gain in revealed advantages, like chemicals and rubber and plastics, or constant competitiveness, as in electrical engineering. In areas where China has gained in competitiveness, the performance of the EU-15 is more mixed. In mechanical engineering and electronic engineering the EU-15 has seen its competitiveness decline. In computers, where China's improvement has been most marked, EU-15's competitiveness has been only modestly affected, which nevertheless means remaining at a low and disadvantaged position. The improvement in China's competitiveness in cars is still modest (with a negative RCA in 2001), while the competitiveness of the EU-15 did not change much and remained positive in the observed period. But given that cars have been targeted as a strategic sector by the Chinese government (cf. below), the trend in China's competitiveness in cars is most likely to be upward. Somewhat surprisingly, the EU-15 has been gaining competitiveness in food and beverages and in textiles and clothing. As regards the latter, the improved situation for European producers reflects the strength of high-end products and luxury brands.

[230] Based on European Commission (2005a).

01_2006_4142_txt_EN.indd 145 12-07-2007 10:43:52

Table 14-2: Revealed comparative advantage: China versus EU15

		Sectors in which EU15 has a deteriorating RCA position		Sectors in which EU15 has more or less maintained its RCA position		Sectors in which EU15 has improved its RCA position	
		No RCA	**RCA**	**No RCA**	**RCA**	**No RCA**	**RCA**
Sectors in which China has a deteriorating RCA position	**No RCA**					Wood (25) Metals (27/28)	Paper (21/22) Chemical (24) Rubber (25)
	RCA		Minerals (26)	Electric (31)	Optical (33)		
Sectors in which China has improved its RCA	**No RCA**		Mechanical (29)		Cars (34/35)		
	RCA	Leather (19) Electronic (32)		Computer (30)			Food&Bev (15/16) Textiles (17/18)

Note: Increase/decrease of RCA considered over the period 1995-2001. Whether a RCA is held or not is evaluated at 2001.

Source: European Commission (2005a).

The challenge posed by China is particularly relevant for the **new Member States**, as Table 14-3 illustrates. Since the mid-1990s, the new Member States have improved their trade performance in car manufacturing, a sector where China has as yet not developed a comparative advantage, despite modest improvements. Sectors with declining EU-10 RCAs are textiles, clothing and leather products, and food & beverages, branches in which the new Member States had performed strongly in earlier times but where they currently face stiff competition on global markets. In all these sectors China is improving its RCAs. Finally, in computers and electronics, where China has taken a tremendous step forward and developed a comparative advantage in both sectors, the new Member States have also improved their position. While they have developed a comparative advantage in electronics, they have so far failed to develop a comparative advantage in computers.

01_2006_4142_txt_EN.indd 146 12-07-2007 10:43:53

Table 14-3: Revealed comparative advantage: New Member States

		Sectors in which EU10 has a deteriorating RCA position		Sectors in which EU10 has improved its RCA	
		No RCA	**RCA**	**No RCA**	**RCA**
Sectors in which China has a deteriorating RCA position	**No RCA**	Chemicals (24) Rubber (25)	Wood (20) Metals (27/28)	Paper (21/22)	
	RCA	Electrical (31)	Minerals (26)	Optical (33)	
Sectors in which China has improved its RCA	**No RCA**			Mechanical (29)	Car (34/35)
	RCA		Food&Bev (15/16) Textiles (17/18) Leather (19)	Computers (15)	Electronic (32)

Note: Increase/decrease of RCA considered over the period 1995-2001; Whether an RCA is held or not is evaluated at 2001.

Source: European Commission (2005a).

14.2. FDI from Europe into China

As already documented in Part I, Europe is not one of the most important investors in China. European FDI engagement in China is very moderate in quantitative terms, accounting for less than 10% of total FDI inflows into China. However, European investment projects in China are on average more technology-intensive compared to FDI from e.g. Hong Kong, Taiwan and South-East Asia.

Table 14-4: FDI inflows into China, 1995-2002

	1995	1996	1997	1998	1999	2000	2001	2002
World	*37,520.5*	*41,725.5*	*45,257.0*	*45,462.7*	*40,318.7*	*40,714.8*	*46,877.6*	*52,742.9*
EU-15	2,131.31	2,737.06	4,171.15	3,978.73	4,506.51	4,479.46	4,182.70	3,709.82
In %	5.7%	6.6%	9.2%	8.8%	11.2%	11.0%	8.9%	7.0%

Source: National Bureau of Statistics, MOFCOM.

Only a very small share of total European FDI outflows finds its way to China.[231] In 2002 the vast majority of the EU-15's outward FDI was directed to other EU-15 Member States. Outside the EU-15, the major destination country remains the US. Despite the substantial increase in FDI inflows to China since the early 1990s, the EU-15 FDI outflows to the new Member States were much greater than those to China.[232] There

[231] A detailed discussion of European FDI in China be found in van den Bulcke et al. (2003).

[232] US firms appear to be investing more in fast-growing emerging countries than their EU counterparts. Asian emerging economies were the destination of 12.3 per cent of US FDI between 1999-2002.

01_2006_4142_txt_EN.indd 147 12-07-2007 10:43:53

would appear, then, to be scope for Europe to develop its investment relationship with China further.

Table 14-5: EU-25 FDI outflows 1995-2004

Euro million and %

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
China	787	1,654	1,816	435	2,254	2,428	2,292	3,102	2,999	2,969
(in %)	*0.6*	*1.2*	*0.9*	*0.1*	*0.3*	*0.2*	*0.4*	*0.6*	*0.8*	*1.0*
India	348	342	606	840	925	733	348	1,074	653	1,036
(in %)	*0.3*	*0.2*	*0.3*	*0.2*	*0.1*	*0.1*	*0.1*	*0.2*	*0.2*	*0.4*
World	**124,099**	**143,393**	**206,573**	**368,197**	**738,674**	**1,126,186**	**632,543**	**494,482**	**393,104**	**295,739**

Source: Eurostat.

The comparatively weak presence of the European economies in China can to a large extent be explained by historical developments in Europe itself. The dynamic progress in the process of European integration and of German re-unification and the sudden accessibility of East European markets has absorbed substantial capital and management capacity that otherwise might have been allocated to ventures in China. The relatively moderate share of the West European economies, however, cannot hide the fact that the absolute volumes of China-bound FDI flows have multiplied over time. For instance, German FDI into China in 2002 was 39 times its 1985 level, for the UK this was a multiplier of 12, and for France 17.

Table 14-6: European FDI Flows to China, 1997-2002, by country

	1997	1998	1999	2000	2001	2002
Austria	74.61	21.13	23.17	22.59	57.78	67.27
Belgium	33.26	28.04	83.22	56.16	20.02	124.28
Denmark	16.81	62.66	84.91	49.46	56.38	71.09
France	474.65	714.89	884.29	853.16	532.46	575.60
Germany	992.63	736.73	1373.26	1041.49	1212.92	927.96
Italy	215.04	274.57	187.44	209.51	219.98	176.74
Netherlands	413.80	718.82	541.68	789.48	776.11	571.75
Spain	38.81	53.83	17.54	34.00	33.89	92.24
Sweden	42.81	133.42	155.80	159.24	84.39	99.80
United Kingdom	1857.56	1174.86	1044.49	1164.05	1051.66	895.76
EU-15	**4171.15**	**3978.73**	**4506.51**	**4479.46**	**4182.70**	**3709.82**

Source: NBS, MOFCOM.

The development of European investment in China follows the general trend of China's market transformation and opening to the world economy. The 1980s were characterised by a wait-and-see attitude reflecting the institutional deficiencies in China's FDI regulations. Since 1992, the overall conditions for foreign investors in China have appeared to be more favourable than ever before. In line with global FDI inflows into China, cf above, European FDI flows towards China picked up markedly. China's membership of the WTO has, generally, provided further stimulus to extend European FDI engagement in China. Depressed business cycles and a concentration on the EU enlargement in May 2004, however, resulted in an overall reduction of European FDI flows to China in 2002.

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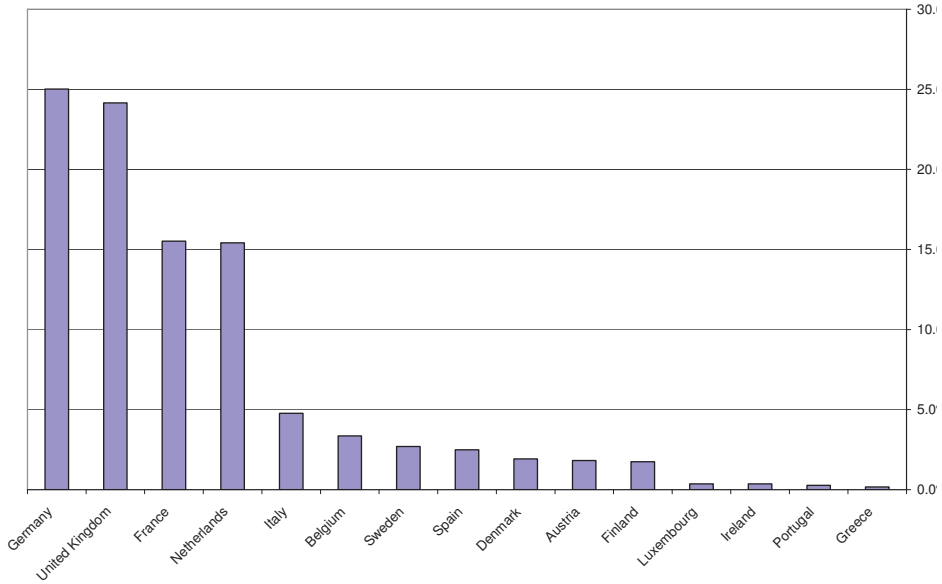
Figure 14-5: European FDI Flows to China, 2002

(In % of total)



Source: NBS, MOFCOM

In the past, European FDI to China has mostly been "resource seeking", and accordingly European investment projects in China are highly concentrated in manufacturing activities. European capital has been attracted by the low cost of production in China and less by the actual size and potential of the Chinese market. Consequently a considerable share of foreign production has been exported, and not been sold on the Chinese market (cf section 14.3).

14.3. Trade performance of foreign firms investing in China[233]

A considerable share of the EU's trade with China is conducted with foreign firms located in China. In recent years about half of the EU-15's export / import trade with China has been conducted with foreign firms. From the foreign firm sector's point of view, however, the EU is not of equal importance, accounting for no more than about one seventh of total trade of foreign firms. Imports by foreign firms from the EU were more important in the early 1990s, while foreign firms' exports to the EU have become the dominant feature only since the late 1990s. Today, exports by foreign firms located in China to the EU surpass their imports from the EU by a wide margin, highlighting the resource seeking character of many foreign firms as well as differing growth rates in their absorption of European capital goods and machinery, on the one hand, and EU imports of light industrial products from China, on the other.

These developments can to a large extent be explained by the trend in global and European FDI in China. EU exports to China are mainly concentrated on capital goods,

[233] Background report to European Commission (2004).

01_2006_4142_txt_EN.indd 149 12-07-2007 10:43:54

especially machinery imported by local enterprises in order to establish or upgrade production facilities. While such exports have been directed to customers in China irrespective of their ownership structures (state, collective, domestic private or foreign) and have therefore been able to develop at an early stage in bilateral trade relations, most EU imports from foreign enterprises located in China are founded in complex, long-term business relationships. A considerable share of these imports is comprised of intra-firm trade, whereby EU enterprises source inputs or final products from their Chinese affiliates. Another part is constituted by (European or third-country) original equipment manufacturers which have relocated their manufacturing plants from a third country (e.g. South East Asia or Eastern Europe) to China in order to benefit from lower production costs and continue to supply their European customers from this new production base. Accordingly, the marked increase in FE exports to the EU goes hand in hand with the establishment of large production capacities by resource seeking FEs as part of the first "boom"-period for China-directed FDI starting in 1992, and is further intensified by China's rising importance as a global production base in the wake of WTO accession in 2001.

14.4. Conclusion

China's WTO commitments have helped create shared opportunities for Chinese and European business. In 2004 the European Union became China's largest trading partner and China the European Union's second largest, behind the US. A considerable share of the EU's trade with China is conducted with foreign firms located in China. European companies are investing in China, but to a lesser extent, leaving further opportunities to be exploited.

Despite the win-win situation in the long run, in the short term there will be restructuring costs to be considered in the EU, particularly in those areas where the EU is losing and China is rapidly building sustainable comparative advantage in world markets, such as electronic and mechanical engineering and potentially also in car making.

01_2006_4142_txt_EN.indd 150 12-07-2007 10:43:54

15. CURRENT EU-CHINA POLICIES

The political side of the EU-China relationship is often perceived by observers as being limited to joint declarations on global multilateralism and promoting democracy, peace and stability. Some analysts wonder whether China and the EU really share the same values, the same interests and the same vision of multilateralism.[234] As a prelude to the final chapter's policy discussion, this chapter reviews the way in which the EU currently engages with China.

15.1. Current EC objectives and institutional set-up

The EU has since 1998 had five long-term aims as regards China:

(i) engaging China further via an enhanced political dialogue,

(ii) supporting China's transition to an open society based on the rule of law and respect for human rights,

(iii) integrating China further into the world economy (WTO, reform, sustainable development, etc),

(iv) making better use of existing European resources, and

(v) raising the EU's profile in China.[235]

These aims were complemented in 2001 by short- and medium-term "action points".[236] On the basis of a 2002 strategy paper, the aims and actions were reaffirmed in a 2003 Communication, timed to coincide with the arrival in power of a new generation of Chinese leaders.[237] The Communication provided an updated list of detailed and concrete action points aimed at delivering the aims outlined above. These action points have since guided the Commission's action. Evaluations are made regularly to verify whether progress has been made.[238]

On the basis of these aims and actions, the European Commission has established an institutional set-up for ongoing dialogue with the Chinese authorities. This is summarised in the graphs below. They illustrate the breadth and depth of contacts, which range from

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234 François Godement, *Emergence d'une Superpuissance. La Chine : Partenaire ou Adversaire ?* Actes de la journée d'études du 14 septembre 2004 organisée par la Fondation pour la Recherche Stratégique – *Alex Berkofsky, EU-China Relations : Strategic Partnership or Partners of Convenience ?* German Foreign Policy In Dialogue, Vol. 6, Issue 6, June 2005 – Bruno Tertrais, *Tectonique des Plaques en Asie*, Notes de la Fondation pour la Recherche Stratégique, 28 septembre 2005

235 European Commission (1998), "Building a Comprehensive Partnership with China", COM (1998) 181.

236 European Commission (2001), "EU Strategy towards China: Implementation of the 1998 Communication and Future Steps for a more Effective EU Policy", COM (2001) 265.

237 European Commission (2003), "A Maturing Partnership – shared interests and challenges in EU-China relations", COM (2003) 533.

238 DG RELEX (2005), "China Action Points/Guidelines for Action - Stocktaking April 2005".

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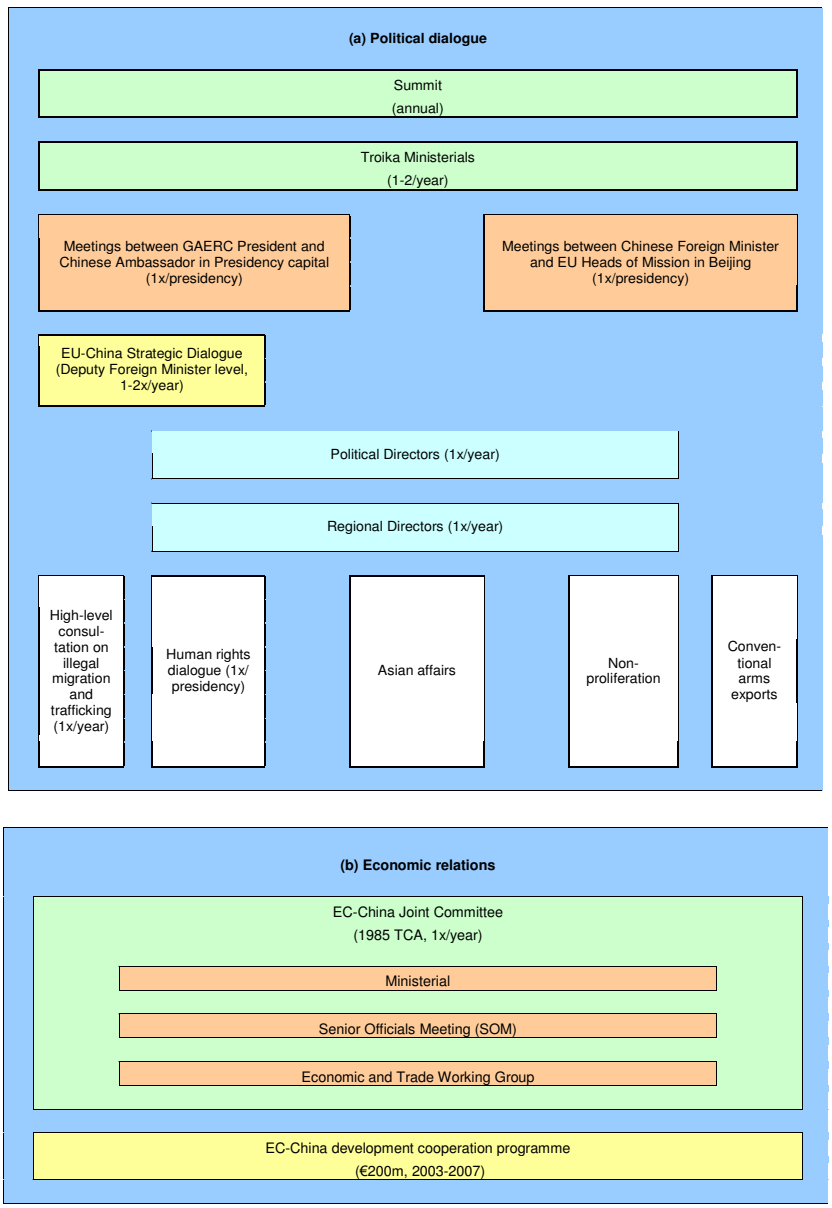
an annual Summit at the most senior policy level covering all areas, to ongoing detailed discussions at service level in specific policy areas.

Figure 15-1: Current architecture of EU-China relations



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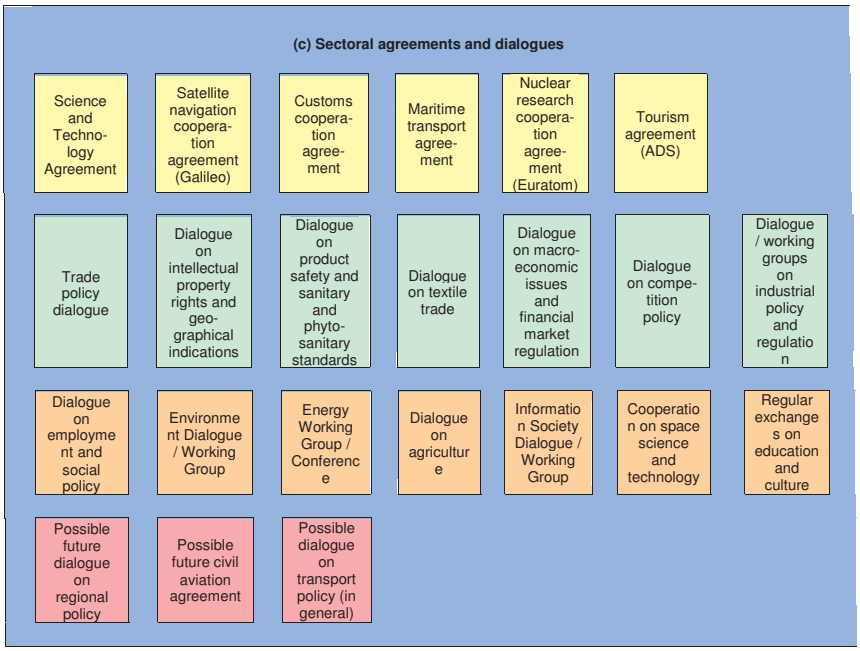
(c) Sectoral agreements and dialogues
Science and Techno-logy Agreement
Satellite navigation coopera-tion agreement (Galileo)
Customs coopera-tion agree-ment
Maritime transport agree-ment
Nuclear research coopera-tion agree-ment (Euratom)
Tourism agreement (ADS)
Trade policy dialogue
Dialogue on intellectual property rights and geo-graphical indications
Dialogue on product safety and sanitary and phyto-sanitary standards
Dialogue on textile trade
Dialogue on macro-economic issues and financial market regulation
Dialogue on compe-tition policy
Dialogue / working groups on industrial policy and regulatio n
Dialogue on employme nt and social policy
Environme nt Dialogue / Working Group
Energy Working Group / Conferenc e
Dialogue on agricultur e
Informatio n Society Dialogue / Working Group
Cooperatio n on space science and technology
Regular exchange s on education and culture
Possible future dialogue on regional policy
Possible future civil aviation agreement
Possible dialogue on transport policy (in general)

Source: DG RELEX (2005), Situation as at 1 December 2005

These dialogues are underpinned by the cooperation efforts of the European Commission in China. For instance, the EU China Trade Programme supports capacity building in China on trade policy issues.

Moreover, the European Commission maintains a delegation employing some 100 people (local staff included). Its only office is in Beijing. A large part of the staff are employed on development cooperation and related activities (finance and contracts). A smaller part are active in economic policy (trade, information society and telecommunications and S&T).

Since 2000, The European Union Chamber of Commerce in China has been the official voice of European Business in China, recognised as such by the European Commission and the Chinese authorities. The core structure of the Chamber is based on Working Groups, which meet regularly in Beijing, Shanghai and Nanjing and discuss business issues in their respective sectors. Each year the ECCC publishes a Position Paper, which details the key concerns and recommendations of each group with regard to WTO implementation issues, trade issues beyond these WTO commitments, regulatory issues and broader policy-related issues.

15.2. EU – China trade policy

The EU's policy vis-à-vis China on trade issues can mobilise a range of resources at a multilateral and bilateral level. First, since China's accession to the WTO in 1992, the monitoring of the full and effective implementation by China of its WTO commitments takes place in a **multilateral** setting. Given that the EU shares similar concerns with other global players, most notably the US, on ensuring China's path towards effective liberalisation, a multilateral approach towards these issues is most natural. While China

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has made substantial progress in implementing its WTO commitments, notably in the tariffs area, there remain substantial non-tariff barrier areas, such as protection of intellectual property rights, open government procurement, investment restrictions, industrial policy etc where more needs to be done to ensure effective market access. In any dispute, the WTO *Dispute Settlement Instrument* can be used to ensure implementation.[239] There is also the *Trade Barrier Regulation*, which allows economic operators to ask the Commission for an investigation. Where there is found to have been a WTO violation, it has to be followed by a WTO case as a DSC. But before, peer pressure (for instance within the context of the yearly Trade Policy Review Mechanism of China) is a useful means of engaging China in a more positive way.

Beyond current WTO commitments, both the EU and China have a strong stake in taking trade liberalisation further, for example in the area of services. More particularly, the importance of bringing the current Doha Development Round to a successful conclusion cannot be overstated. However, for the moment, China's appetite for taking an active role in these negotiations has not been commensurate with its new role in world trade. Instead, it seems to prefer a policy of bilateral and regional trade agreements rather than putting effort into supporting multilateral negotiations.

At the **bilateral** level, the EU and China have a multitude of Sectoral Dialogues, as discussed above. Together with the meetings of the Joint Committee, the Economic and Trade Working Group and the annual summits, these provide ample opportunity for contacts. These contacts have grown out of the 1985 Agreement.

Overall there is a feeling that on many trade and market access issues, like IPR, progress is only limited, questioning the effectiveness of the EU's trade policy instruments. Should the EU be more aggressive? Does it employ enough resources? Is it analysing China correctly? To increase the effectiveness of its trade policy instruments, the EU should also look beyond trade policy to leverage other policy areas (cf below).

15.3. EU and China: two visions of foreign policy

The EU's commitment to its founding principles of human rights, democracy and the rule of law, and its attachment to promoting good governance and effective multilateralism, are the main pillars of its policy vis-à-vis China, as illustrated by the overall political and sector dialogues outlined above. On China's side, the Five Principles of Peaceful Coexistence, which include non-interference in other countries' internal affairs, are the basis of its foreign policy in general and also vis-à-vis the EU. These two perspectives may collide.

China's first ever policy paper on China-EU relationship in 2003 refers clearly to the Five Principles and emphasises that "there is no fundamental conflict of interests between China and the EU and neither side poses a threat to the other. However given their differences in historical background, cultural heritage, political system, and

[239] The EU has already once launched a DSC against China for auto parts. The TBR has so far not been used against China.

01_2006_4142_txt_EN.indd 154 12-07-2007 10:43:58

economic development level, it is natural that the two sides have different views or even disagree on some issues."[240]

If disagreements are managed in a way that respects the interests of the two parties, it will show that the EU-China relationship is mature enough to accommodate disagreements while agreeing on fundamentals. However historical, cultural and political differences may lead not only to different views but also to misunderstandings and misinterpretations.

15.3.1. Human rights

In the lead-up to the 2005 EU-China Summit, Amnesty International's EU Office welcomed "the fact that the EU has made the lifting of its arms embargo contingent on human rights reform", but stressed that "concerns remain in all areas under scrutiny. The Chinese government has yet to present a coherent plan of reform and steps to improve its human rights practices must be implemented in a clear and consistent manner." Amnesty International called on the EU to "keep pressing the Chinese authorities for such steps in the debate around lifting the arms embargo on China." Actually the EU is actively engaged in fostering a frank and constructive exchange on human rights issues with China and stimulating the positive trends. The EU has notably launched a number of projects to support NGOs which are active in the areas of promoting and protecting human rights in China. The EU has constantly stressed that more should be achieved in the field of civil and political rights, in particular with regard to freedom of expression, religion and association and protecting the rights of minorities. Moreover the EU does attach great importance to the release of the people imprisoned at the time of Tiananmen – or who later commemorated the 1989 events.

However, a number of observers consider that so far no significant progress has been made on the EU-China human rights dialogue initiated in 1996. In particular and despite EU's repeated requests, China has not yet given any timetable for ratifying the International Covenant on Civil and Political Rights (ICCPR) and insists it will take place on China's terms. Whether the EU-China dialogue on the rule of law will achieve further results remains to be seen. The EU insists that the rule of law is not synonymous with rule by law while on the whole Chinese official documents refer more to the latter than to the former.

15.3.2. Good governance

The EU genuinely believes that it can help China to achieve a better governance capacity. In line with its founding principles the EU is seeking to assist China in this transition period so that the country can move toward a more open society, and a more representative and accountable government. However, some Chinese scholars see hidden motives and double standards behind Europe's stance.[241] Moreover, some Chinese scholars believe that conflicts in ideology and values still remain in the China-EU

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[240] China's EU Policy Paper, October 2003.

[241] For example, David Shambaugh, a well-known US expert on China, notes that China's Europe specialists have begun to criticise the motives underlying the EU programme to promote civil society in China as an ideological ruse to "westernise and divide" China. David Shambaugh, *The New Strategic Triangle : U.S. and Europe Reactions to China's Rise*, The Washington Quarterly, Vol.28, Issue 3, Summer 2005, pp.7-25

01_2006_4142_txt_EN.indd 155 12-07-2007 10:43:59

relationship.[242] Huo Zhengde of the China Institute of International Studies, for example, considers the EU's support for China's reform, opening-up and transformation into a society based on respect for democracy and the rule of law as an attempt to prompt China to accept Western ideology and to become more integrated with the international community. He also stresses what he regards as the EU's ambiguous international role, i.e. the EU being in favour of multilateralism while at the same time being inclined to intervene in other countries' internal affairs, as illustrated by the 1999 bombing of Yugoslavia and the recent interference in Ukraine's internal affairs.

15.3.3. Multilateralism

Though the EU is committed to multilateralism there is an impression of "selective bilateralism". Some fear that Europe is running a risk of finding itself marginalised in the regional development of Asia – Asem and other dialogues notwithstanding. China is by far the most important actor in the region for European interests and it has already been argued that the sino-centricism of the Europeans might result in other Asian nations being neglected. Moreover, there is no clear-cut regional leadership accepted by all countries in the region.

15.3.4. International order

China's quest for resources, its strict compliance with the principle of non-interference in other countries' internal affairs, and the political ramifications of its relations with countries such as Iran or Sudan pose the risk of a substantial undermining of the EU's capacity to influence other (developing) countries in the direction of good governance, human rights and political freedom (see Chapter 4).

15.4. The EU, its Member States and China: a complex picture

Several analysts view the EU's China policy as a clear example that the policies made in Brussels are not necessarily the policies of all Member States.

On China's side the challenge is to deal with the EU as a whole as against dealing with the Member States individually. China has already complained that the EU has gained an unfair advantage by hiding behind differing EU Member States' policies on issues such as the lifting of the arms embargo. Even if the development of a Common Foreign Security Policy (CFSP) over the coming years were to lead to an increasingly significant EU role in shaping and managing the world order, the EU is not yet a comprehensive foreign security player. The Chinese are fully aware that foreign policy remains in the hands of Member States and that power – as defined by military means, sovereignty, and even the possibility of influencing outcomes at the UN – remains vested at the national level and that this will remain the case for the foreseeable future. China's bilateral relationship with Member States still serves as the basis of its multilateral relationship with the EU.[243] Moreover many analysts consider that the EU is currently a regional force and not a global force and that it will more likely develop into a decisive force for the world rather than into a power *per se*.

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[242] Huo Zhengde, *On China-EU Strategic Relationship*, China Institute of International Studies, April 2005 - http://www.ciis.org.cn/item/2005-04-07/50919.html who

[243] Huo Zhengde, ibid.

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On Brussels' side the challenge is to discuss issues such as promoting democracy, human rights, and the rule of law with a degree of insistence that does not spoil either the EU Member States' bilateral relations with China or the EU's trade relations with China. Some European experts wonder whether Member States see a role for EU policy towards China going beyond trade or whether they prefer to pursue their own China policies on a bilateral basis. China is sensitive to Europe's desire to stand tall on the international stage, convinced as it is that the emergence of a multipolar world is inevitable. In other words if the EU can become a pole it is because of China's status in the evolving balance of world power.[244] In this regard some analysts consider that China is using the strategic partnership for its own purpose, urging Brussels to lift its arms embargo and transforming such a decision into an EU affirmation of independence from the United States that will ultimately show the EU's political maturity. This is illustrated by statements from some Chinese officials, arguing that the EU should have "the courage" and the "statesmanship" required to act, i.e. to lift its embargo whatever the US position may be.[245]

15.5. The EU, the US and China: the risks of a triangular relation

Will the EU-US relationship be increasingly shaped by their views on how to adjust to China's rise? How is the EU going to play its geopolitical card between a firmly established pole, the United States, and an increasingly sino-centric pole? Can Europe continue to push its European/national interests in China if it risks alienating the United States? Since Asia's rise could eventually contribute to a multipolar world, whereby the United States retains its supremacy but has lost much of its legitimacy, and as China is inclined to see the American democratisation policy in the rest of the world as a part of a hegemonic strategy, these questions are legitimate. Moreover, China's continued development will not solely be of its own making – it will also depend on the West's response.

15.5.1. The EU and the US – two different perspectives on China

The EU and the United States have differing interests. That is primarily because the EU, unlike the US, has no significant security strategic interests in the region nor is it expected to act as a regional security guarantor. As one analyst has put it: "Europe has the luxury to develop its relationship with China unencumbered by the strategic and security responsibilities that the United States shoulders in Asia or the domestic role that the Taiwan lobby plays in Washington."[246]

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[244] Feng Zhongping of the China Institute of Contemporary International Relations (CICIR) thinks that the EU-China relationship will help the EU "in its long cherished endeavour to assert itself on the world stage and become an independent "pole" in world affairs". See Feng Zhongping, *Analysis of the China Policy of The European Union*, Contemporary International Relations, Vol.8, Issue 4, April 1998 – Michael Pillsburg, *China Debates the Future Security Environment*, National Defence University Press, January 2000

[245] Huo Zhengde sees the EU's eventual decision on the lifting of the embargo as a test of "the quality of the China-EU partnership, EU's independence of the US, its stance on the potential crisis on the Taiwan Straits and on the US strategic position and role in the Asian-Pacific region." However, he also points out that China and the EU are not a security threat to each other. Moreover, they do not need each other or depend on each other as regards strategic security in the Asian pacific region. That is in sharp contrast "with the situation in which China and the United States are potential strategic rivals while needing each other strategically." Huo concludes that at this stage the "China-US and the EU-US relations are more important than the China-EU relations."

[246] David Shambaugh, ibid.

01_2006_4142_txt_EN.indd 157 12-07-2007 10:44:00

Economic issues dominate the EU's thinking on China, while the security perspective on China is of relatively little importance. As one scholar has said, "European countries do not appear to have any clearly identified strategic interests in or politico-military assessment of the regional security environment in East Asia, they have not made a systematic assessment of the strategic implications of changes in Chinese military power."[247] From a strategic standpoint it could be argued that given a European approach to China which is predominantly economic, and the determination of China to acquire know-how and technology, the EU's main concern is to know whether European exporters will be able in the longer term to continue expanding the market share for their products in China while ensuring control over their core technologies. However, how would the EU react to a possible crisis in the Taiwan Strait (should the EU remain neutral or should it throw its full weight behind the U.S.?) is an issue which should be seriously considered as well.

The situation is more complex for the United States, which is an influential presence and a security guarantor, as illustrated by its bilateral alliances in the region and the political links it has forged since 1945. This explains the American tendency to focus primarily on China's external posture and its military modernisation. The US concerns are fourfold: Taiwan, the future of the Asia Pacific region, energy and trade. All four have a potential for conflict.

The asymmetry between American and European interests in the region is a fertile ground for misunderstandings, and many observers believe that there are strategic limits that Europe should not cross. The discussion between the two sides over the European arms embargo and its potential lifting was a case in point.[248]

15.5.2. The EU's and the United States' shared interests towards China

The EU-US-China triangle is potentially unsettling if two sides manoeuvre against the third. However, the limits to the triangular game can be clearly drawn once it is acknowledged that Europe and the United States have much more in common in terms of common values and global interests.

Europe and the United States agree that the most important issue is to manage China's smooth and peaceful integration into the established global system. Both have an interest in China being a status quo power rather than a revisionist power. Both want to engage

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247 An Anthony, *Military Relevant EU-China Trade and Technology Transfers: Issues and Problems*, Conference on "Chinese Military Modernization: East Asian Political, Economic and Defence Industries responses" , organised by CSIS, 19-20 May, 2005

248 François Godement, director of the Paris-based IFRI Asia Centre, thinks that this issue showed the limits of the "strategic partnership" between the EU and China. He describes this partnership as having been conceived on the basis of Chinese commercial ambitions and the existing tools for European action in Asia, i.e. European soft diplomacy's tools. Such a partnership can work only in calm times but cannot run the risk of provoking a crisis in China-United States relations. See François Godement, *La Relation Chine-Europe et Ses Implications Stratégiques*, IFRI, 31 mars 2005.

Bruno Tertrais of the Fondation pour la Recherche Stratégique (FRS - Paris) notes that "the modernisation of the People's Liberation Army (PLA) is to be able to resist the United States power, to be in a position to blackmail Taiwan and to bolster the PLA's ability to maintain internal order", and he asks; "are Europeans keen to signal China that they are ready to contribute to helping Beijing satisfy these goals?" He concludes that "we do not need another transatlantic crisis. Such a crisis would play in the hands of those who may have a political interest in transatlantic division, including in China." See Bruno Tertrais, "Europe and the Emergence of China. Consequences for the Transatlantic Relationship. A European Perspective", Fondation pour la Recherche Stratégique.

01_2006_4142_txt_EN.indd 158 12-07-2007 10:44:00

with China in the widest possible range of international institutions. They also share the hopes of seeing China rise to become a responsible major power, a reliable economic partner and an increasingly pluralistic and democratic state.

This broad commonality of values and interests should be taken further. Europe and the United States should at least consult with each other and attempt to work out common positions over China and more broadly over Asia wherever possible. Indeed "to the extent that the Chinese believe that Europe is sympathetic toward the need to balance and constrain US power, they may be more likely to indulge in such thinking themselves. If instead they see the United States and Europe coordinating their policies on matters of common interests, from the Middle East to global issues to China itself, the Chinese may be more likely to see the advantages of cooperation not merely for now but for the long haul."[249]

[249] David C. Gompert, François Godement, Evan S. Medeiros, James C. Mulvenon, *China on the Move: A Franco-American Analysis of Emerging Chinese Strategic Policies and Their Consequences for Transatlantic Relations*, Rand 2005

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16. EU POLICY OBJECTIVES

The European economy is inextricably linked to the world economy, and it is essential for European firms to be able to access international markets, exploit efficiency advantages and access strategic assets in order to stay competitive. Being a part of the world economy enables Member States to specialise according to their evolving comparative advantages but also exposes the EU economy to constant economic shocks and a continuous process of structural change. To be a successful partner in the world economy therefore requires an ability to adapt.

Integrating China into the world economy is just another facet of this overall challenge posed by globalisation, albeit in view of China's size and rapid rise, a sizeable one. Just as with the world economy, the EU benefits tremendously from trading with China.

The **fundamental policy goals** are therefore to (i) promote China's orderly integration into the world economy and become a stakeholder in the structures governing it and (ii) to enable the EU to maximise the benefits and minimise the costs that derive from globalisation and China's economic rise. To achieve these fundamental goals, the EU should pursue six **objectives**. First, the EU should base policymaking on a sound understanding of China. Second, based on this knowledge of China and the challenges it is facing, EU policy should aim to help China succeed. Third, in engaging with China, EU policy should also aim to maximise the opportunities for EU firms and minimise the risks they are facing. Fourth, to sustain the support for economic openness, EU policy should also help to boost Europe's capacity to adapt to the challenges China presents. Fifth, EU policy should promote an open world economy, keeping our markets open while achieving effective market access to the opportunities offered by China. Finally, EU policy should play a constructive role in promoting what can appropriately be called "harmonious international relations" by being a constructive and reasoned voice in the East Asian region. These objectives, and the action needed to achieve them, are further outlined below.

16.1. Base policymaking on a sound understanding of China

EU policymaking needs to be based on a sound understanding of where China currently stands and where the country and the region are going. Building this understanding means improving analytical capacity, including economic analysis. The goal should be to acquire a better understanding of where China stands on its development path, what its genuine policy objectives are, the direction in which its comparative advantage is evolving, what challenges it is facing and its long-term develpment. It also includes political analysis, where the EU needs to improve its understanding of the different forces at work within the ruling party and the different currents of political thought in China. Achieving this will require the following action:

- ***Refocus local presence and knowledge***. The EU Delegation in China is currently focused primarily on development cooperation, with relatively less weight devoted to monitoring the EU's economic and political interests (trade, investment, telecom, science and technology, etc). This is in line with the EU's traditional focus on facilitating transition and reform. That work is important and will benefit the EU in the long term. However, more resources are needed to monitor direct interests in the economic and political field.
- ***Strengthen analytical capacity at Commission headquarters in Brussels***. The Commission should review current administrative resources devoted to China.

01_2006_4142_txt_EN.indd 160 12-07-2007 10:44:01

Taking into account budget constraints, the scale of China-devoted resources should nevertheless be more proportional to the economic and strategic importance of the partner.

- ***Build up analytical resources over the medium term***. Several studies show that knowledge of China is relatively weak and dispersed in the EU across the board, be it in economic or political issues, at the level of governments (the Commission and Member States), universities and think tanks. This is particularly the case when when we look at the level of China expertise in the United States.

  To build up a larger pool of expertise may need devoted funding. There is also a need to improve interaction between (i) the Commission and outside experts and (ii) Commission and Member States and (iii) the EU and China. The ECAN, EU-China Academic Network, initiative is an interesting first step in this respect. It is an EU supported network of academic institutions encouraging collaboration among researchers on contemporary China.

- ***Develop a coherent policy stance.*** The EU's China policy is determined by a multitude of players (within the Commission, between Commission, Council and Member States, etc). Developing a coherent policy stance calls for coordination.

  It requires coordination *within the Commission*. Currently coordination is informal and is judged to be working rather well. Nevertheless, the Commission should assess the strengths and weaknesses of this informal coordination of the EU's overall position and everyday China-related actions undertaken by various departments. Arguably, China has become so important and most issues have come to require a systemic approach, that a coordinated policy response is systematically sought. While informal coordination is effective, and desirable, its ad hoc nature appears insufficient in view of China's omnipresence and importance. Overall, the Commission could consider setting up a main interdisciplinary hub that centralises information.

  It also requires *coordination between the Commission and Member States*. Particularly on trade and FDI issues, Member States too often see themselves in competition for China's attention rather than in cooperation. For instance, in Trade Policy the Commission speaks on behalf of the Member States. The complementary area of Trade Promotion falls within the Member States' sphere of competence. Closer coordination between the two areas would increase overall efficiency. Naturally, the EU's problems in this respect are generic.[250] To build up a common strategic outlook and vision between Member States with respect to external policy is a long-term endeavour. It is a worthwhile one though, particularly with respect to China. Divergences clearly sow confusion and decrease the EU's influence in China and the East Asian region at large

- ***Improve effectiveness of policy.*** The EU should also boost its effectiveness by coordinating with global trading partners and prioritising. The EU should coordinate China-related actions with global trading partners that share similar interests and views, as this may provide leverage. The recent joint WTO challenge with the US is a useful example and we should see to what extent such joint actions are feasible on a broader scale.

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[250] Better co-operation between EU institutions and Member States is an issue addressed by the Communication from the Commission to the European Council of June 2006: "Europe in the World – Some Practical Proposals of Greater Coherence, Effectiveness and Visibility"; COM(2006) 278 Final – 8 June 2006.

01_2006_4142_txt_EN.indd 161 12-07-2007 10:44:01

The depth and breadth of current EU-China cooperation and dialogue is impressive. However, the recent proliferation of dialogues makes it difficult for the Commission to effectively manage and deliver meaningful results in all areas. It is therefore better to increase but also focus scarce resources on the most strategic areas.

16.2. Help China succeed

A harmoniously developing China is of major benefit to Europe, when it is fully integrated and open to the world. It is therefore in our interest to assist China to address the challenges it is facing, and where possible help the Chinese in their transition and reform process. The EU has traditionally focused on helping to manage the internal transition and reform process, to improve governance, strengthen civil society and the rule of law. This support has worked well.

Moreover, the Community and the individual Member States have a wealth of policy experience when it comes to political and economic reform, e.g. as regards the build-up of competition policy, social welfare systems, administrative capabilities and the like. Moreover, the most recent enlargement brought in Member States that have only recently gone through a profound process of economic and political transition.

One important instrument at the EU's disposal is development assistance. This instrument should be put to better strategic use. Nevertheless, as development assistance resources are scarce and as China becomes richer and increasingly able to take care of its internal problems on its own, international donors, the EU included, need to reconsider the size of the private and public aid financial flows to China. The difficulty in the case of China's rapid growth is to balance her legitimate needs as an emerging economy and her status as an exporting power that is becoming increasingly effective as an international competitor.

China's build-up of its Science and Technology can be achieved in close international cooperation, within current Chinese and EU S&T Programmes. The EU has opened its Research Framework Programme (FP6) to China's participation. It has also opened the Galileo flagship programme to China. Within ERA-NET, there is the CO-REACH initiative, recently launched to stimulate research cooperation with China by coordinating bilateral programmes. Current Community and Member State programmes in the field of education, such as the Erasmus Mundus Programme, could be geared even more strongly towards international cooperation and exchange between China and the EU. More attention should be given to actively promoting existing programmes to stimulate participation by the best EU and Chinese scholars and to make sure these programmes are leveraged into long-term benefits for all sides.

16.3. Maximise economic opportunities and minimise risks for EU firms

As evidenced above, international business is welcome in China and is regarded as important in China's development as, especially from EU firms, it contributes technology and know-how. The Chinese market is a tremendous opportunity for EU firms where they can exploit efficiency advantages, access strategic assets and develop a customer base.

With each side being able to exploit its relative strengths, there is the potential for this to be a win-win situation. Nevertheless, many uncertainties remain. China is a market and a society characterised by rapid flux, where the institutional framework underpinning the economy has not fully kept track and where national sentiments are increasingly present. Therefore, foreign companies may find it difficult to access Chinese markets, particularly

01_2006_4142_txt_EN.indd 162 12-07-2007 10:44:01

in 'strategic' sectors. And their (intellectual) property rights are not always fully protected. While to a large extent this is a legacy of an old institutional framework, there are increasing signs of intentional elements of industrial policy favouring national champions, and lack of compliance with copyrights, intellectual property and the like.

EU firms establishing a presence in China need to recognise this uncertain reality with extensive opportunities mixed with risks. EU firms should therefore carefully evaluate the risks associated with their presence. Foreign investors need to be flexible, have a long-term vision and build on their innovative capabilities to meet the hyper-competitive Chinese market. Crucially, EU firms need to manage their intellectual property rights assets strategically to sustain their advantage in the long run.

EU policy makers cannot afford to be naïve. They should fully recognise and understand the reality of Chinese policy and continue to make the case for open markets. In addition, they should support the business community by:

- Supporting language and business training for Europeans doing business in China, and vice versa. The Commission supported the establishment of the China Europe Business School (CEIBS) in Shanghai, which provides high quality business training to young Chinese and international students. It should also support specific training in European business schools on doing business in China.

- Backing the development of information and support services to help EU firms, especially SMEs, into China.

- Stimulating and coordinating export promotion and the organisation of trade missions. Although export promotion is the prerogative of Member States, and the EU should not try to substitute for them, some coordination could help to increase visibility and efficiency, particularly for smaller Member States.

16.4. Improve Europe's capacity to adapt

It is important to put the economic challenge associated with China's rise in context. The challenges associated with trade are only part of the everyday dynamism of a market economy. Of this limited trade-related aspect, China is so far only a small part with accordingly little in the way of employment effects.

However, there are reasons for concern. First, the pace of China's transformation and rapid build-up of comparative advantage in a broad number of areas, including higher technology, is unprecedented. Second, comparative advantages of several Member States are increasingly overlapping with China's. Third, the European economy is inadequately equipped to adapt smoothly and reallocate resources in response to shocks.

To address these concerns, the crucial challenge is to improve the European economy so that globalisation and competition from China are no longer a threat to jobs, but an opportunity for growth. To achieve this, the European economy needs to improve its adaptive capacity. Policy should therefore have two goals: (i) improving competitiveness and (ii) facilitating transition. Much of this is embodied in the now revised, but ever-important Lisbon Strategy.

16.4.1. Improve competitiveness

There are a number of things that EU policy could do to improve the EU's competitiveness.

01_2006_4142_txt_EN.indd 163 12-07-2007 10:44:02

- Companies ultimately locate where the market is. EU policy should therefore strive to provide a dynamic European market and should nurture a vigorous entrepreneurial culture. This can be done by providing access to a large, integrated and growing market. There are well-known challenges related to the EU's quest to achieve a full internal single market, and Commission action as regards improving regulatory quality, achieving further liberalisation (notably in services), and minimising barriers to entry and control of incumbents remains as important as ever.

- EU policy should also strive to support an environment conducive to firms moving into high value-added production. This can be done by e.g. stimulating and improving research spending and taking actions to increase the likelihood of innovations being translated into new value added (e.g. stimulating the emergence of risk capital markets). EU policy could also create a better environment for businesses. Another important goal for EU policy should be to invest in human capital, thereby improving the skills of the workforce.

- EU policy should also aim to improve the European economy's structural ability to adapt and adjust to shocks. This can be achieved by promoting further structural reforms – aimed in general at reducing regulatory burdens, increasing labour market participation and upgrading the stock of human capital. A crucial part is likely to be labour market reform aimed at providing effective employment protection, improved participation and enhanced safety and health conditions.

16.4.2. Facilitate transition

There is a role for policy to temporarily cushion the impact on incomes of workers affected by structural change, while facilitating re-employment. While Member States' social insurance systems have been devised in part to meet such needs, EU policy can contribute, e.g. by using the recently agreed European Globalisation Adjustment Fund (EGAF), which will provide support for the rapid redeployment of workers displaced by sudden and major trade shocks. The EU can also initiate a debate on how to review the policies and incentives for individuals to take up new work by reassessing tax and benefit systems, and providing customised and speedy job search and placement assistance.

In order to cushion the regional impact of China-related economic shocks, EU policy could consider short-term assistance to regions suffering severe trade-related shock, provided that such assistance does not run counter to the overall goal of ensuring a reallocation of resources economy-wide.

16.5. Maintain and promote an open world economy

China is in the process of assuming its natural place in the world economy.. But economic leadership brings responsibility. The EU should try to "enmesh China in the widest possible range of international institutions" and should draw China into a responsible role of cooperative global leadership, notably as regards the rules-based system of economic governance.

The EU should lead by example, keeping our market open in order to allow our consumers and firms as well as other countries – including China – to benefit from the opportunities associated with economic openness. The EU should therefore strive to maintain open access to our internal market and avoid misuse of the safeguards that trade rules put at our disposal to respond to protectionist demands.

However, it will be increasingly difficult to defend openness in the years to come, as the EU grapples with the problems of adapting to challenges and as China (more wrongly

01_2006_4142_txt_EN.indd 164 12-07-2007 10:44:02

than rightly) is viewed as the main culprit of painful trade-induced change. The policy response outlined above (objective 4) would enable Europe to cope more effectively with the kind of challenge presented by China. However, convincing citizens of the benefits of maintaining openness while facilitating change requires a well thought-through communication strategy.

This challenge will be stronger if China does not allow meaningful and effective access to its market. Therefore, the economic openness should be embedded in reciprocity. Chinese economic nationalism is bad for the world, but it is also bad for China in the long run. China has benefited spectacularly from its reinsertion into the world economy. This economic might is increasingly lending it political influence. However, with power comes responsibility for the principles, norms, rules and procedures underpinning the world economy. Clearly, China's interests are heavily dependent on open markets, as its past growth performance has made clear. China has a clear interest in an open trade and investment environment. Indeed, in many cases China has shown a willingness to shoulder this responsibility. But challenges remain. A number of areas can be highlighted:

- ***International trade (WTO)***. In general, China is keeping up with its schedule of complying with WTO commitments; in some areas it is even ahead. While most tariffs and quotas have been eliminated as foreseen, effective foreign penetration in Chinese markets often remains limited. As one set of barriers are dismantled (i.e. tariffs), others become more glaring (i.e. non-tariff barriers). Policy will have to focus more on factors hampering de facto market access. It is essential for the EU to have full access to China's rapidly growing market. Especially in "strategic" goods and service sectors, like cars and petrochemicals, banking and telecom, effective market access remains an issue. A number of areas stand out:

  - *Intellectual property rights*. Despite significant progress, there is still no proper enforcement of intellectual property rights; significant counterfeiting remains, leading to major losses for EU firms. China needs to make IPR protection more consistent, notably as regards enforcement (inter-agency coordination needs improving). At the same time, EU companies should be encouraged to use complementary strategic protection mechanisms.

  - *National treatment*. Still preferential treatment for domestic companies in some areas, notably in public procurement, subsidies and easier access to funding by SOCBs for local firms, especially SOEs, investment restrictions in a number of sectors, where the EU has a strong advantages such as the automotive sector and the petrochemical sectors (50%). In other sectors, real investment opportunities have been restructured by high capital and liquidity requirements (banking) and licensing procedures (telecom services).

  - *Standards*. While adopting certain international standards, China relies largely on domestic ones. Participation in standard-setting bodies is often not transparent and not open to foreign participants.

  - Moreover, within the Doha Round, China could become more active in pushing for further liberalisation beyond current commitments. Eventually, it would be natural for China tp indicate a willingness to take on further liberalisation commitments.

- ***Global imbalances***. These are currently at unprecedented levels, and there are significant risks of a disorderly adjustment. China, like Europe, has a role to play.

01_2006_4142_txt_EN.indd 165 12-07-2007 10:44:03

Delivering on commitments is not going to be easy, as illustrated by Europe's difficulties in delivering meaningful structural reform. Nevertheless, China needs to gradually reduce excess savings and revalue the Yuan.

However, addressing the problem of excess savings is a long-term endeavour that requires careful execution, and includes improving the financial system so that savings can be better channelled into the real economy and improve social welfare systems to reduce current incentives for precautionary saving.

Being able to do that without risking economic disorder means speeding up the restructuring of the financial system and putting in place a more comprehensive social welfare system. There is a compelling domestic case for China to carry out these reforms, as this will lay a solid foundation for future high levels of growth. However, it is all a matter of ensuring an orderly transition. So far, just as the US has so far failed to address its lack of savings, the moves on the exchange rate side are clearly insufficient to make a meaningful contribution to dealing with the imbalances. A more meaningful move is in Europe's interest, as otherwise the dollar is likely to depreciate more against the euro.

16.6. Promote 'harmonious' international relations

- **Engaging China.** Apart from enmeshing China in the various institutions which underpin the world economy, it is also important to anchor China in the wider international system. China is at a "strategic crossroads". It has the potential for both good and bad and will in any case exercise considerable influence. Most probably, as the Chinese say, "harmony with other nations despite differences" is an achievable goal but the question is how many differences can be accommodated without disturbing the "harmony" of the international system. In this respect, China needs to recognise that lack of transparency (e.g. on China's military build-up) and actions contradictory to official statements (e.g. on relations with some countries, notably in Africa) lead to unsettling questions on China's real intentions. Europe's interest is to push China towards the more positive course while avoiding two traps: being viewed as an interventionist, even "imperialist" force, and surrendering its founding principles. Overall, the EU is well placed to engage with China. While the EU's position not homogeneous, the EU and China nevertheless broadly share a fairly benign view of multipolarity and multilateralism.
- **Regionalism.** Asia is a diverse and unstable region that is currently undergoing fundamental changes. A number of countries in the region are busy building domestic institutions, and nationalism is high. The region is the focal point of China's economic and political rise. This has generated tough competition for regional leadership, with the outcome being uncertain. With China being only part of an Asian manufacturing value chain, with intensive intra-FDI and trade flows between Japan, Korea, Taiwan, China and other Asian countries, the EU needs to develop an overall Asia Strategy. Europe's interest is in promoting a stable regional order and avoiding any suspicion of a hidden bilateral agenda or preference. The EU's unique experience – Member States willing to share sovereignty in a number of areas – can be put to good use in the emerging regionalism in the East Asian region. While it is far from clear which direction East Asian integration is going (divergence of views, historical sensitivities, unequal power balance, etc), the EU should broadly support East Asian cooperation and integration (within Asean etc).
- **United States.** The United States is an important regional player and certainly the single most important country in terms of China's national interests. For the EU, the relationship with the United States is considered to be "Europe's most comprehensive

01_2006_4142_txt_EN.indd 166 12-07-2007 10:44:03

and strategically most important partnership." When developing a China/East Asian policy, it is essential that the EU understands US views, shaped as they are by the US's long-standing involvement in the region and extensive bilateral security guarantees developed after the Second World War (e.g. with Japan, Taiwan, South Korea, etc). This security dimension profoundly shapes the US views. While the EU-US link may form the bedrock of the current security system (e.g. NATO), views/interests vis-à-vis China/East Asia may well diverge. Nevertheless, Europe shares a fundamental strategic interest with the United States, i.e. to integrate China peacefully into the existing multilateral system. The EU should not let China take advantage of possible divergences between European and American policies, in particular regarding China. In view of this broad commonality, there is a need to carefully manage EU-US relations by discovering and dealing with potential differences well in advance.

- **The way forward.** The assessments on China's future and its implications for the international community diverge considerably, but there is agreement on the uncertainty of any future developments. The EU should build on China's desire for a stable environment within which to pursue and sustain its economic growth. This a period when the EU should be:
    - Encouraging China towards a smooth transition;
    - Encouraging China to play a more responsible and constructive role in world affairs;
    - Approaching China while keeping in mind the rest of the region – and keeping in mind Europe's transatlantic relationship as well;
    - Enhancing the EU's sensitivity to security concerns.

  To engage more effectively with China, the EU needs to establish a more visible political presence. While frequent high-level visits are useful, their effectiveness would be improved if they EU could speak with one voice. Naturally, the EU's problems in this respect go beyond China. To build up a common strategic outlook and vision between Member States – e.g. within the CSFP – is a long-term endeavour. It is a worthwhile one though, as divergences clearly sow confusion and lessen the EU's influence in China and the East Asian region at large.

01_2006_4142_txt_EN.indd 167 12-07-2007 10:44:03

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01_2006_4142_txt_EN.indd 171 12-07-2007 10:44:04

LIST OF TABLES, GRAPHS AND BOXES

TABLE 1-1: ADMINISTRATIVE DIVISION 5
TABLE 2-1: CHINA'S ECONOMY COMPARED 15
TABLE 2-2: SOURCES OF OUTPUT GROWTH 19
TABLE 2-3: PRIVATE VERSUS PUBLIC SECTOR IN THE CHINESE ECONOMY: % OF VALUE ADDED BY FIRM OWNERSHIP 22
TABLE 2-4: CHINA'S MANUFACTURING STRUCTURE: SHARE OF VALUE ADDED BY PRIVATE SECTOR IN MAJOR INDUSTRIES (2003) 22
TABLE 2-5: TRENDS IN CHINA'S SHARE IN WORLD FDI FLOWS 25
TABLE 2-6: SHARE OF FOREIGN ENTERPRISES IN CHINA'S INDUSTRIAL PRODUCTION GROSS INDUSTRIAL OUTPUT VALUE BY SECTOR 2003 28
TABLE 2-7: SOME S&T INPUT INDICATORS FOR CHINA 31
TABLE 2-8: HUMAN CAPITAL FOR S&T INPUT INDICATORS FOR CHINA 33
TABLE 2-9: PUBLICATIONS AND CITATIONS BY COUNTRY 36
TABLE 2-10: INTERNATIONAL PATENT APPLICATIONS (NUMBER AND SHARE) 36
TABLE 3-1 SHARE IN WORLD MERCHANDISE TRADE BY REGION, 2004 40
TABLE 3-2: CHINA'S REVEALED COMPARATIVE ADVANTAGES IN GLOBAL TRADE, 1995, 1998, 2001 45
TABLE 3-3: TRADE PATTERN AND COMPARATIVE ADVANTAGE BY STAGE OF PRODUCTION 47
TABLE 3-4: CHINA'S OUTWARD-BOUND FDI FLOWS AND FDI STOCK, MIO. US$ 49
TABLE 3-5: CHINA'S TRADE IN ENERGY 51
TABLE 3-6: CHINA'S TRADE IN RAW MATERIALS 51
TABLE 5-1: MACRO-ECONOMIC FUNDAMENTALS IN CHINA 76
TABLE 6-1: PROFITABILITY OF CHINESE AND INTERNATIONAL BANKS (END 2003) 81
TABLE 6-2: FOREIGN INVESTMENT IN CHINA'S BANKS 84
TABLE 7-1: THE IMPORTANCE OF FINANCING CONSTRAINTS FOR CHINESE ENTERPRISES AND THE CONSEQUENT IMPORTANCE OF RETAINED EARNINGS AS A SOURCE OF FINANCE 94
TABLE 8-1 SOCIAL SECURITY CONTRIBUTION RATES 104
TABLE 10-1: GDP AND EMPLOYMENT 117
TABLE 13-1: SELF-IDENTIFICATION MEASURE 127
TABLE 14-1: EU-15 TRADE WITH CHINA BY BROAD PRODUCT GROUPS 142
TABLE 14-2: REVEALED COMPARATIVE ADVANTAGE: CHINA VERSUS EU15 146
TABLE 14-3: REVEALED COMPARATIVE ADVANTAGE: NEW MEMBER STATES 147
TABLE 14-4: FDI INFLOWS INTO CHINA, 1995-2002 147
TABLE 14-5: EU-25 FDI OUTFLOWS 1995-2004 148
TABLE 14-6: EUROPEAN FDI FLOWS TO CHINA, 1997-2002, BY COUNTRY 148

List of Figures

FIGURE 1-1: CHINA'S PROVINCES 4
FIGURE 1-2: CHINA'S STATE ORGANS 7
FIGURE 2-1: FDI INTO CHINA BY COUNTRY OF ORIGIN 26
FIGURE 2-2: RATIO OF R&D EXPENDITURE TO VALUE-ADDED BY OWNERSHIP 30
FIGURE 3-1: WORLD EXPORT MARKET SHARES FOR DIFFERENT COUNTRIES/COUNTRY GROUPINGS (MANUFACTURING) 41
FIGURE 3-2: CHINA'S WORLD MARKET SHARE OF IMPORTS BY PARTNER 42
FIGURE 3-3: CHINA'S TOP 10 TRADING PARTNERS 2005 43
FIGURE 3-4: TRADE BALANCE OF CHINA VIS-À-VIS TRADING PARTNERS (2005, BILL USD) 44
FIGURE 3-5: WORLD EXPORT MARKET SHARES FOR TELECOMMUNICATION AND COMPUTERS 45
FIGURE 3-6: CHINA'S OVERALL TRADE IN INTERMEDIATE GOODS BY MAIN TRADING PARTNERS 48
FIGURE 3-7: CHINA'S OVERALL TRADE IN CAPITAL GOODS BY MAIN TRADING PARTNERS 48
FIGURE 6-1: DOMESTIC CREDIT PROVIDED BY BANKING SECTOR (% OF GDP, 2004) 79
FIGURE 6-2: FOREIGN BANKS' SHARE OF THE BANKING MARKET (2003) 83
FIGURE 6-3: EQUITY MARKETS IN EMERGING MARKETS (SHARE GDP) 85

01_2006_4142_txt_EN.indd 172 12-07-2007 10:44:05

FIGURE 6-4: MARKET CAPITALISATION AND MARKET CAPITALISATION OF TRADABLE SHARES TO GDP 86
FIGURE 8-1: STRUCTURE OF SELECTED GOVERNMENT REVENUES (2003) 99
FIGURE 8-3: TOP EXPENDITURE ITEMS 102
FIGURE 10-1: EMPLOYMENT AND GDP 115
FIGURE 10-2 REGISTERED URBAN UNEMPLOYMENT 116
FIGURE 10-3: MIGRATION 119
FIGURE 11-2: INEQUALITY IN CHINA COMPARED TO OTHER DEVELOPING COUNTRIES 121
FIGURE 11-3 INEQUALITY WITHIN CHINA 122
FIGURE 14-1: SHIFTS IN THE GEOGRAPHICAL FOCUS OF EU-15 EXPORTS (MANUFACTURING) 140
FIGURE 14-2: EU-15 TRADE WITH CHINA 141
FIGURE 14-3: EXTRA-EU-15 TRADE BALANCES 141
FIGURE 14-4: SHARE OF MANUFACTURING EXPORTS TO THE EU-15 BY TYPE OF SECTOR 144
FIGURE 14-5: EUROPEAN FDI FLOWS TO CHINA, 2002 149
FIGURE 15-1: CURRENT ARCHITECTURE OF EU-CHINA RELATIONS 152

List of boxes

BOX 1-1: A SNAPSHOT OF CHINA'S RECENT HISTORY 3
BOX 1-2: MEMBERS OF THE POLITBURO'S STANDING COMMITTEE 8
BOX 1-3: THE EIGHT DEMOCRATIC* PARTIES 9
BOX 1-4: CHINA'S ELEVENTH FIVE-YEAR PROGRAMME (2006-2010) 10
BOX 1-5: CHINA'S DEFENCE WHITE PAPER – COMMAND OF THE SEA, COMMAND OF THE AIR AND STRATEGIC COUNTER-STRIKES 13
BOX 2-1: LISTS OF MAJOR REFORMS FOR ECONOMIC GROWTH 16
BOX 2-2: ECONOMIC IMPACT OF CHINA'S WTO ACCESSION 17
BOX 2-3: CHINA'S ECONOMIC STRUCTURE 20
BOX 2-4: THE ECONOMIC PRESENCE OF HONG KONG AND TAIWAN ON THE MAINLAND .. 27
BOX 2-5: MAJOR CHINESE GOVERNMENT R&D FUNDING PROGRAMMES 32
BOX 2-6: FOREIGN PROVIDERS OF HIGHER EDUCATION 34
BOX 2-7: CHINA'S PARTICIPATION IN ERASMUS MUNDUS EXCHANGE OF STUDENTS AND SCHOLARS 35
BOX 2-8: THE GLOBALISATION EXPERIENCES OF CHINA AND INDIA COMPARED 38
BOX 4-1: CHINA RUSSIA RELATIONS 60
BOX 4-2: THE TAIWAN ISSUE : THREE DIFFERENT VIEWS ON THE STATUS OF TAIWAN 63
BOX 4-3: CHINA AND THE DEVELOPING WORLD 72
BOX 5-1: WHAT IS THE "FAIR" VALUE OF THE RENMINBI? 77
BOX 7-1: CHINA'S INDUSTRIAL POLICY 93
BOX 7-2: CHINA'S COMPETITION LAW 97
BOX 10-1: HUKOU: A SYSTEM OF REGISTRATION IN PROGRESS 118
BOX 14-1: CHINA, THE EU AND IT 144
BOX 14-2: CHINA, TEXTILES, THE EU AND THE WTO 144

01_2006_4142_txt_EN.indd 173 12-07-2007 10:44:05

List of Acronyms

Asean:	Association of South-East Asian Nations
APEC:	Asia-Pacific Economic Cooperation
CASS:	the Chinese Academy of Social Sciences
CCB:	City Commercial Banks
CCP:	China's Communist Party
CEIBS:	China-Europe International Business School
CEPA:	Closer Economic Partnership Agreement (between China and Hong Kong)
CFSP:	Common Foreign and Security Policy
CICIR:	China Institute of Contemporary International Relations
CNY:	Chinese Yuan
GSP:	Community System of Generalized Tariff Preferences
CPPCCS:	People's Political Consultative Conferences.
CSRC:	China's Securities Regulatory Commission.
EU:	European Union
FDI:	Foreign direct Investment
FEER:	Fundamental equilibrium exchange rate
FRS:	Fondation pour la Recherche Stratégique (FRS - Paris)
FTA:	Free Trade Agreements
GATS:	Generalised Agreement on Trade in Services
GDP:	Gross Domestic Product
GERD:	Gross Expenditures on R&D
ICCPR:	International Covenant on Civil and Political Rights
ICT:	Information & Communication Technology
ILO:	International Labour Organisation
IMF:	International Monetary Fund
IPR:	intellectual property rights
JSB:	Joint Stock Banks
KMT:	Nationalist Party or Kuomintang
LLC:	limited liability companies
LP	Legal Person (LP)
MNE:	Multi-national Enterprise
Mofcom:	Ministry of Finance and Commerce
MOST :	Ministry of Science and Technology
NBS:	National Bureau of Statistics
NELG:	National Energy Leading Group
NGO:	Non-Governmental Organisation
NMS:	New Member states (EU)
NNSF:	National Natural Science Foundation
NPC:	National People's Congress.
NPL:	Non-performing loans
OECD:	Organisation for Economic Co-operation and Development
PLA:	People's Liberation Army.
PPP:	Purchasing power parity
PRC:	People's Republic of China
PRI:	Public Research Institutes
R&D:	Research and Development
RCA:	Revealed comparative advantage
RCB:	Rural Commercial Banks
RMB:	Renminbi
S&E:	Scientists & Engineers,
S&T:	Science and Technology
SAIC :	State Administration of Industry and Commerce
SASAC:	the State Assets Supervision and Administration Commission
SCI	Science Citation Index
SCO:	Shanghai Cooperation Organization
SEAsia:	South-East Asia
SEPA:	State Environment Protection administration
SIPO:	in Chinese patents
SME:	Small and Medium-sized enterprises
SOCB:	State Owned Commercial Banks

01_2006_4142_txt_EN.indd 174 12-07-2007 10:44:06

SOE:	State Owned Enterprises
TAC:	Treaty of Amity and Cooperation in Southeast Asia
TVE:	Township and Village Enterprises
UN:	United Nations
Unctad:	United Nations Conference on Trade and Development
US:	United-States
USPTO	United States Patents and Trademark Office
VAT:	Value-Added Tax
WFOE:	Wholly foreign-owned enterprises
WHO:	World Health Organization
WIPO	World Intellectual Property Organisation
WTO:	World trade organisation

01_2006_4142_txt_EN.indd 175 12-07-2007 10:44:06

01_2006_4142_txt_EN.indd 176 12-07-2007 10:44:06

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